FUNDAMENTAL TAX REFORM AND OTHER TAX ISSUES

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

FEBRUARY 27 and MARCH 26, 1985

Serial 99–14

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
49-179 O WASHINGTON : 1985

H781-53

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FUNDAMENTAL TAX REFORM AND OTHER TAX ISSUES

WEDNESDAY, FEBRUARY 27, 1985

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[Press releases announcing the hearings follow:]

[For immediate release, Wednesday, Feb. 6, 1985]

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, Announces Hearings on Fundamental Tax Reform and Other Tax Issues

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced public hearings on the basic concepts involved in fundamental tax reform and hearings on other specific tax issues pending before the Committee.

HEARINGS ON FUNDAMENTAL TAX REFORM

The Committee will begin public hearings on the basic concepts involved in tax reform, simplification and fairness on Wednesday, February 27, 1985. The hearings will be held in the main hearing room, 1100 Longworth House Office Building, beginning at 10 a.m. The first witness will be the Secretary of the Treasury, the Honorable James A. Baker III.

The hearings will involve testimony on the policy concepts underlying fundamental tax reform proposals, including the Treasury proposal announced in November 1984, and other similar proposals that have been the subject of recent analysis and debate.

The general public is requested to prepare testimony with reference to the basic policy issues in the tax reform proposals that have been put forward. A specific date for beginning the public phase of these hearings will be announced after an appropriate interval to afford the public an opportunity to evaluate Secretary Baker's testimony.

In announcing these hearings, Chairman Rostenkowski stated, "It is essential that we begin consideration of fundamental tax reform. We cannot ignore the opportunity—or responsibility—that has been presented. To understate the obvious, the American people are frustrated by the complexity of the tax form and disillusioned by a sense of unfairness in the law. Thus, it is imperative that the tax code be scrutinized from top to bottom with simplicity, equity and fairness as our goals."

HEARINGS ON OTHER TAX ISSUES

Once the Committee's agenda relative to fundamental tax reform and deficit reduction is established, the Committee anticipates scheduling consideration of other tax issues—many of which involve expiring tax provisions—at appropriate intervals during 1985. The first such issue will be a full Committee hearing on Tuesday, March 5, 1985, on the recently revised IRS regulations regarding record keeping requirements for automobiles and other property. The hearing will be held in the

Committee's main hearing room, 1100 Longworth House Office Building, beginning at 9:30 a.m.

The Committee anticipates hearings sometime this spring on (1) a bill making technical corrections to the Deficit Reduction Act of 1984 (which is expected to be introduced in March); and (2) imputed interest (in view of the July 1, 1985, expiration of the stopgap legislation enacted in October 1984). In addition, the Committee anticipates consideration, prior to their expiration on October 1, 1985, of (1) the cigarette excise tax (presently, 16 cents/pack, scheduled to decrease to 8 cents/pack), and (2) superfund. The Committee may also consider several other tax provisions which are scheduled to expire on December 31, 1985.

In identifying these issues, Chairman Rostenkowski stated, "I want to emphasize that while many of these expiring provisions may be politically popular, they can not be judged or evaluated in isolation from their revenue consequences. In view of the massive deficits confronting the nation, a special burden must be carried by those who advocate extension of costly, expiring provisions."

DEFICIT REDUCTION AND OTHER LEGISLATIVE MATTERS

In addition to the Committee activity on tax issues, as in previous years, Ways and Means will be deeply involved in the legislative efforts of the House to reduce the Federal deficit. The Administration's budget contains proposed reductions in the medicare and public assistance programs under the Committee's jurisdiction. With regard to these proposals, Chairman Rostenkowski said, "action on tax reform and other matters will not divert us from our responsibility to make every effort to reduce the deficit. The Committee will thoroughly review the Administration's budget reduction proposals, as well as alternative measures, within the coming weeks."

[For immedidate release, Friday, Mar. 15, 1985]

The Honorable Dan Rostenkowski (D., Ill.) Chairman, Committee on Ways and Means, U.S. House of Representatives, Announces a Day of Public Hearings at Which the Principal Congressional Authors of Tax Reform Bills Have Been Invited to Testify

The Honorable Dan Rostenkowski (D., Ill.), chairman, Committee on Ways and Means, U.S. House of Representatives, today announced another day of public hearings on the basic concepts and principles underlying comprehensive tax reform. On Tuesday, March 26, 1985, Members of Congress who are the principal authors and sponsors of specific comprehensive tax reform bills have been invited to testify before the Committee. This hearing will be held in the main Committee hearing room, 1100 Longworth House Office Building, and will begin at 10 a.m.

In his letter of invitation, Chairman Rostenkowski asked invited Members to discuss the basic concepts involved in fundamental tax reform as well as the provisions in their bill. In his letter, he said, "The Committee would particularly appreciate testimony on the economic impacts, relative burdens, revenue consequences and simplification features of your proposal."

This hearing is continuation of the fundamental tax reform hearings that began with the appearance of Treasury Secretary James A. Baker on February 27, 1985. Additional hearing dates for public witnesses will be announced later.

Chairman ROSTENKOWSKI. The committee will come to order.

Welcome, Mr. Secretary, to the Committee on Ways and Means. You have brought with you a big contingent from your office at the Treasury Department.

Mr. Secretary, I am sure you agree that the American people are increasingly frustrated with our tax systems and feel that the tax law favors a few at the expense of many; that the law is overly complex and invites avoidance. I believe that we all feel the same about the need for fundamental tax reform.

But enacting a sweeping tax reform bill means stepping on a lot of big feet. I am sure that may very well happen in the next 6 or 7 months. I feel very strongly, Mr. Secretary, that the President of the United States is the most important ingredient in the tax reform process which I hope will be conducted on a very cooperative bipartisan basis.

I think that the President's initial endorsement of what the former Secretary of the Treasury recommended last November was somewhat of a surprise not only to Republicans, but Democrats alike. I truly believe that the President has issued the call. He has struck the populist chord and has stirred millions of taxpayers. I agree with him that there are millions of taxpayers that feel that the present tax system is unfair.

If the country wants tax reform, I am sure that it will be reflected through the Members of Congress on this committee. Mr. Secretary, I hope that you can reassure us that the administration is prepared to roll up its sleeves with us, work with us, and continue to press for early action on a consensus plan.

In the meantime, I will move the committee into full hearings, beginning with congressional authors of various tax reform proposals, in mid-March.

Jim, I bid you welcome on behalf of the committee. I know you to be a totally honorable, sincere, dedicated public official—a man who, in private conversations, I have grown to respect greatly. I just hope that we, the Committee on Ways and Means and the administration, can write a fair and just tax bill.

Mr. Duncan, do you have a statement?

Mr. DUNCAN. Thank you, Mr. Chairman.

To begin with, let me join in welcoming Jim Baker at his first official appearance here as Secretary of the Treasury. It will, I am sure, be one of many appearances before the Committee on Ways and Means.

Mr. Secretary, I certainly look forward to an opportunity to work with you during the coming years, and I know that your performance at Treasury will be as exemplary as your performance in the past 4 years in the White House.

Turning to the most important issue before this committee, the reform and simplification of our existing tax laws, let me emphasize that I share Chairman Rostenkowski's concern about their complexity and recognize the need to make them fairer and simpler, not only statutorily, but in the eyes of the American people.

My colleagues on this side of the committee have been advocating such improvements for a number of years. In this pursuit, I think it is very important that we proceed cautiously in considering both the Treasury's reform package and the other similar packages which have been introduced in the Congress.

There are many issues that need to be investigated and studied thoroughly. Perhaps the first and most important question is whether changes of the magnitude proposed will produce a system which shows improvements enough to warrant the economic disruptions that it might cause.

We cannot, I think, in these hearings ignore the fact that many aspects of our economy are vitally and fundamentally affected by the existing tax system.

Mr. Secretary, we look forward—all of the members of our side and, I am sure, both sides—to working with you and being very close to you in deliberations throughout the year.

Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Secretary, you may proceed.

STATEMENT OF HON. JAMES A. BAKER III, SECRETARY, DEPARTMENT OF THE TREASURY

Secretary **Baker**. Thank you very much, Mr. Chairman. It is a pleasure for me to be here today. Because this is my first appearance before this committee, as well as the first appearance of any administration spokesman on the subject of tax reform, with your permission, Mr. Chairman, I would like to depart from what has become, over the course of three or four appearances up here, my standard practice of asking that my opening statement be included in the record.

With your permission, sir, I would like to read my opening statement in its entirety.

Chairman **Rostenkowski**. That is fine.

Secretary **Baker**. Earlier this month in his State of the Union Address, the President called for a "Second American Revolution," a revolution of hope and opportunity for all Americans. He stressed the idea that freedom is the key to this revolution's success.

For the economy, freedom means less arbitrary interference by Government. Freedom means that the marketplace, and not Government, determines what businesses produce and how they produce it, and how that production is organized and financed.

Freedom means that the marketplace and not Government shapes individual consumption and investment decisions. Freedom means that the tax structure must be designed to be as neutral as is practicable with respect to business and investment decisions.

Absent compelling reasons to the contrary, the tax system must not be used to favor one taxpayer over another, to favor one industry over another, to favor one form of consumption over another, or to favor one investment over another. To perpetuate these favortisms in the absence of such reasons would be to restrain economic freedom and deny the American people a standard of living they could otherwise obtain.

This is why fundamental tax reform is so important. A tax system that is unfair, that is unnecessarily complicated, and that interferes with everyday economic decisions being made by businesses, investors and consumers is a tax system that restrains economic growth, and economic growth is crucial to a second American revolution.

The economy is currently experiencing its strongest sustained rate of growth since the mid-1960's. We are in our 27th month of economic expansion. Real growth for 1984 alone was the highest it has been since 1951. During the first 2 years of the current expansion, real growth, at a 6.1-percent annual rate, has been the strongest for any expansion since the economy pulled out of the strike-depressed recession trough of late 1949 and into the Korean war boom.

This growth has generated employment levels never before attained in the history of our Nation. During this period of expansion, 7.3 million jobs have been created.

Importantly, this growth has taken place without high inflation. Over the last 3 years, inflation has averaged just 3.9 percent. In none of these years has it exceeded 4 percent. Last year, as measured by the GNP deflator fourth quarter over fourth quarter, inflation was the lowest it has been since 1967.

Prospects for continued growth without inflation are excellent, provided that we act promptly and boldly to continue what we have begun. The President has instructed, as a part of this plan of action, to begin work with Congress to develop bipartisan tax reform legislation to further nurture economic growth that will provide prosperity for all to share.

Common threads are woven into the fabric of most of the major reform proposals under serious consideration. Therefore, even though there are marked differences among these plans—and there will undoubtedly have to be compromises—there are sufficient similarities and a sufficient sharing of common principles that we have ample basis to begin a serious bipartisan effort.

We are willing to reexamine all of the provisions of the Treasury package in light of the thoughtful views and comments we have received, and will receive, from taxpayer groups, members of the business community, Members of Congress and their staff, distinguished experts and—not least—the sometime forgotten Americans, the so-called ordinary taxpayers.

That is what the President had in mind when he asked me, on his behalf, to work with Congress to develop bipartisan legislation that will reform and restructure our tax system for fairness, simplicity, and economic growth. Only if Congress and the administration share a common commitment will we be able to enact such historic legislation, and do it this year.

The President, in his State of the Union Address on February 6, 1985, enumerated some of the goals of tax reform. These goals were: tax reform will not be a tax increase; the home mortgage interest deduction will not be jeopardized; personal tax rates will be reduced by removing many preferences, with a top rate no higher than 35 percent; corporate tax rates will be reduced while maintaining incentives for capital formation; and individuals living at or near the poverty line will be exempt from income tax.

Mr. Chairman, I am here today at your request to open those working discussions with you and members of this committee. As I indicated to you in our earlier conversations, I can testify today only with respect to general principles. I am not yet prepared to discuss provisions of the Treasury Department's study in detail. I will, of course, be prepared to testify in detail subsequently as your hearings on this vital subject progress. Today, I would like to open the dialog by elaborating on the principles to which we believe fundamental reform should conform.

PRINCIPLES FOR TAX REFORM

We believe that the American taxpayer—individual workers, investors, retirees, and businessmen—have enormous capacity to make sound decisions that will strengthen the economy for the benefit of all. This is not a new notion, but its implications for public policy have not been followed for decades. The tax system has long been misused to try to serve one special interest or another.

Most economists agree on one thing: whenever the tax structure is designed to function in a capacity other than to raise revenues to finance Government activities, there will be a misallocation of productive resources—labor and capital—away from their most productive uses. Only the market forces of supply and demand can allocate resources in such a way as to optimize economic growth; any other allocation, no matter how well intended and how carefully planned, runs the risk, in the long run, of leading to a lower standard of living for all of us.

LOW TAX RATES

This administration believes that tax rates are too high and must be reduced. High tax rates stifle incentives to work, to save, and to invest; they discourage invention, innovation and risk-taking; they encourage wasteful tax shelter "investments"; and they stimulate underground economic activities generally. Thus, our first principle for tax reform is that it is far better to levy a low rate of tax on all income than to tax only some income at extremely high rates. By bringing untaxed income into the tax base, we can reduce high marginal tax rates for both individuals and corporations without any loss of revenues in the short run. In the longer run, those lower rates should lead to even higher revenues through sustained growth of the tax base.

The Treasury proposals replace the current 15 tax brackets with a simple three-bracket system, with tax rates set at 15, 25, and 35 percent. The top individual income tax rate of 35 percent is exactly half the top rate when this administration took office. It should be no higher.

The Treasury proposals lower the top corporate income tax rate from 46 percent to 33 percent. Low corporate rates are essential in order to maintain capital formation incentives under a broad-based tax reform plan. Also, it is desirable that the top corporate tax rate and the top individual income tax rate do not differ markedly. Otherwise, the tax system will continue to have an unhealthy influence on the form of business organization.

Tax rates in the range proposed by the Treasury Department, as well as those adopted by the leading congressional alternatives, go a long way toward removing pressure for preferential tax treatments because exemptions and deductions will simply not be worth as much under a low rate structure as they are now. Moreover, any remaining distortions will be less troublesome.

REVENUE NEUTRALITY

We must not allow total revenue to decline and exacerbate the deficit, nor can we permit a hidden tax increase to masquerade in a tax reform disguise. Fundamental tax reform must—and can—stand on its own. The issue of fundamental reform must not be confused with the deficit reduction issue. Each has independent merit and importance. Both are top economic priorities, but fundamental tax reform legislation and deficit reduction legislation must continue on two separate tracks.

In order to achieve low rates of tax without experiencing declining revenue, sufficient untaxed income must be brought into the tax base to offset the rate cut. The arithmetic is elementary. The tax rate times the tax base equals total tax revenue.

This principle of revenue neutrality imposes a special discipline. We cannot give in to special interests bent upon retaining particular exemptions, deductions or credits and still have significantly lower tax rates.

FAIRNESS FOR FAMILIES

As the President said in his State of the Union Address, we believe those living in or near poverty should not pay income tax. They simply do not have the ability to pay tax since their entire incomes are required for subsistence. Consequently, a principle with which few will quarrel is that tax-free income levels be raised enough that families and individuals with income levels at or near poverty be exempt from the Federal income tax.

This can be accomplished by a combination of increases made to the personal exemption and the zero bracket amount. For example, under the Treasury proposals, a family of four would never be required to pay tax on the first $11,800 of income, no matter what its income.

Another principle that the President has endorsed is retention of the deduction for home mortgage interest expense. The sense of well-being and social stability that has always been associated with widespread home ownership sets this one deduction apart for special consideration.

A final fairness principle is that tax reform should not redistribute our current tax burden among those at different income levels. I agree with the conclusion of the Treasury Department study that it is pointless to enter into a debate over the distribution of tax burdens among income classes. Thus, except for somewhat larger tax reductions at the bottom of the income scale that are required to remove those at or near poverty from the tax rolls, the current distribution of taxes should be maintained.

ECONOMIC NEUTRALITY

Economic neutrality, as well as basic fairness, requires that all income should be taxed equally, no matter how the income is earned or how it is spent. This uniform treatment of all sources and uses of income requires a broad and comprehensive definition of income. Therefore, most special exclusions and adjustments and many deductions now in the law that favor certain sources and uses of income must be eliminated. So, too, we must get rid of many special tax credits and tax deferrals. While perfect economic neutrality is too much to expect, we should make every effort to see to it that any tax reform legislation is as economically neutral as possible.

SIMPLICITY

As more and more special features have been added to the income tax laws over the years, the tax system has become so complicated that 41 percent of all individuals filing tax returns—and about 60 percent of those itemizing their deductions—employ professional tax preparation services.

Even Internal Revenue Service staff experts trained to answer taxpayer questions can sometimes give conflicting answers to identical questions. This is not faulty tax administration. It is faulty tax law. Because of the enormous volume of ever-changing statutory provisions, regulations and rulings, the tax law is simply too ponderous for the tax professional, as well as the average person, to master.

If requirements to keep records on itemized deductions and income tax credits are eliminated, as most tax reform proposals would do by scaling back their use, the typical middle-income taxpayer will be relieved of much of the complexity he or she faces today. Also, a simpler tax structure would pave the way for development of a "return-free" system, whereby most taxpayers could elect to have their taxes computed by the Internal Revenue Service entirely on the basis of information reports filed with the Internal Revenue Service by employers, other payors of income, and payees of expenses such as mortgage interest.

Perhaps most important, a simpler, understandable tax system—one without need for so many special rules, cumbersome definitions, and legal jargon—will be perceived as more fair by taxpayers generally. I believe that when many taxpayers complain about complexity, they are, in fact, expressing frustration that tax burdens are unfair. They know that those with equal incomes do not always pay the same tax, and that those with unequal incomes frequently do pay the same tax. This understanding of our current system erodes taxpayer morale and fosters noncompliance.

FAIR AND ORDERLY TRANSITION

Last, but as important as any other principle I have enumerated, is the need for fair and orderly transition. The movement from our current tax structure, with all of its faults, inequities and economic distortions, to a more reformed and more neutral tax structure will inevitably cause shifts in economic resources—shifts that can involve substantial hardships and economic disruptions unless careful and generous transition rules are developed. If the movement is too sudden or too rapid, economic disruptions could be quite serious.

Despite their validity, we cannot allow these arguments to be used to impede fundamental tax reform or to delay its enactment, but we can, and will, be sensitive to concerns of taxpayers who have made good-faith decisions in reliance on current law. Further, we will maintain vigilance to identify other potential inequities that may arise to cause short-run economic turmoil.

There is at present a great deal of uncertainty over when tax reform legislation might be enacted and over the effects such legislation would have on various businesses and investments. This uncertainty may be altering taxpayer decisions or causing such decisions to be accelerated or postponed in order to avoid the effective dates of possible legislation. We do not know the extent to which such distortions in economic activity may be occurring, but we believe it is important that the uncertainties created by the debate over tax reform be held to a minimum.

Accordingly, let me state now, Mr. Chairman, that no administration tax reform proposal will contain an effective date earlier than January 1, 1986. In line with this position, we have modified the effective date and transition rules of the Treasury Department tax reform proposals by substituting January 1, 1986, wherever the rules were previously tied to the date tax reform was either introduced or enacted. Details on these and certain other modifications of effective dates and transition rules of the Treasury proposals are contained in an appendix to my statement.

EFFECTS ON TAX REFORM

Exactly what tax reform will mean to individual taxpayers and to the economy generally is obviously a critical issue because legislators will be influenced by the answers. The Treasury proposals, along with the major congressional alternatives, have been widely discussed in the press, although often evaluations have missed the mark because they reported premature analyses based on incomplete information or a misunderstanding of the proposals.

Under any one of the proposals meriting serious consideration, there will be those with tax increases and there will be those with tax decreases. However, if the Treasury proposals are any guide, families with tax cuts will outnumber families with tax increases by more than two to one. In fact, under the Treasury proposals, 78 percent will experience either a tax cut or no change in tax, and only 22 percent will face higher taxes. Of this 22 percent, more than half will have a tax increase of less than 1 percent of income. This means, for example, that while most families with, say, $50,000 of income would received a tax reduction, those with an increase in tax would typically have an increase of no more than $500.

Like individuals, businesses that pay little or no tax now will face higher taxes. Those that pay the highest rates of tax on total income under the current system will, by and large, receive the greatest benefits. Those businesses are concentrated in industries that do not enjoy many of the special tax-reducing provisions of current law. This group includes, especially, industries which typically have much of their capital in the form of structures, technical know-how and inventories.

Under any of the comprehensive tax reform proposals, long-term real growth would be encouraged by a combination of increased incentives to work and to save, brought about by lower marginal tax rates and a reduction in the distortions in the allocations of capital and labor, brought about by a more neutral tax environment.

CONCLUSION

I do not underestimate the difficulty of the task we face. I have no deadline for submission of an administration proposal. However, it is not nearly as important that a date be set for us to return with specific language as it is for us to continue a productive dialogue. By working together, I do believe—as does the President—

that we can enact this year a tax bill for fairness, simplicity and growth.

Although the changes I have announced today in proposed effective dates and transition rules should permit ordinary business activity to be conducted without significant disruption, it must be recognized that uncertainty and the possibilitity of economic distortions will continue as long as the debate over tax reform continues. No set of effective dates or transition rules, however finely crafted, can protect all taxpayers and all investments from the effects of a fundamental reform of our tax system. Only final action on tax reform legislation will permit businesses and ordinary citizens alike to proceed free of uncertainty over tax consequences.

The Treasury plan is a good starting point. The foundation of the Treasury study—which shares common philosophy and principles with the widely discussed congressional proposals—is sound. Let us now reexamine each provision of the various plans to construct a workable and viable basis for legislation.

I have instructed my staff to reconsider every provision of the Treasury Department plan upon which people have commented to us. They are reviewing every recommendation that business and taxpayer groups alike have made, and they are looking anew at options that were dismissed or possibly overlooked.

We will not abandon the effort to achieve the principles I earlier discussed, but you will find us openly receptive to sound alternatives, and eager to embrace those alternatives if they are more workable. We will be prepared to make any changes necessary as long as we find compelling reasons to do so where such changes might abridge our principles.

In considering any changes, let us keep in mind those who do not really have an organized lobby in Washington—the average working taxpayer. For the majority of working Americans, tax reform represents a fairer, simpler tax system with dramatically lower tax rates. Although many existing deductions, exclusions, and credits would be eliminated, for the majority of taxpayers any resulting increases in tax burdens would be more than offset by the substantial rate cuts and increased personal exemptions and zero-bracket amounts.

That is why it is so important that any changes we consider do not do great injustice to our principle of revenue neutrality. This principle forces a measure of discipline upon us that has rarely constrained the legislative process.

If we are to succeed in reforming the income tax structure—and I hope we will—success will be the result of a dedicated bipartisan effort. That success will engender new respect not only for the tax system, but for Government generally. Taxpayers will be treated more fairly. Workers and families will have greater ability and incentive to save and to invest. The economy will be stronger and America will be greater.

Thank you very much, sir.

[An appendix to the statement follows:]

APPENDIX

FOR IMMEDIATE RELEASE
February 27, 1985

CONTACT: Charles Powers
(202) 566-2041

TREASURY DEPARTMENT ANNOUNCES MODIFIED EFFECTIVE DATES AND TRANSITION RULES FOR TAX REFORM PROPOSALS

Secretary of the Treasury James A. Baker, III today announced modifications in the effective dates and transition rules for certain of the proposals described in the Treasury Department's November, 1984 report to the President entitled Tax Reform for Fairness, Simplicity, and Economic Growth. In that report, the Department stated that any fundamental reform of the federal income tax structure needed to be accompanied by fair and orderly transition rules in order to prevent significant economic disruptions. Subsequently, both Secretary Baker and former Secretary of the Treasury Donald T. Regan expressed the Department's intention to provide for orderly transition and requested taxpayers to comment on the adequacy of the transition rules contained in the Treasury report.

The Treasury Department received comments from many concerned individuals and businesses that current investment plans have been affected by uncertainty over when tax reform legislation might be enacted and over the possible effects of such legislation. Because of the Department's concern that uncertainties attributable to the debate over fundamental tax reform be held to a minimum, Secretary Baker announced today that, notwithstanding contrary provisions contained in the Treasury report, no administration tax reform proposal will contain an effective date earlier than January 1, 1986. The Department amplified by explaining that a number of proposals in the Treasury report contain effective dates, transition rules, or binding contract exceptions tied to the date tax reform legislation is introduced or enacted. In line with Secretary Baker's announcement, January 1, 1986 will be substituted wherever a proposal in the Treasury report contains an effective date, transition rule, or binding contract exception tied to the date of introduction or enactment of legislation.

The Treasury Department also announced intended modifications of the transition rules and effective dates of the proposals for indexing interest and limiting investment interest deductions. The proposal to index interest payments and receipts, which is described in Chapter 9.03 of volume 2 of the report, would become effective January 1, 1989, rather than January 1, 1988. In addition, application of the fractional exclusion rates described in Chapter 9.03 would be phased in over a 10-year period beginning on January 1, 1989. That is, in 1989, 10 percent of the applicable fractional exclusion rate would be applied to interest payments and receipts; in 1990, 20 percent of the applicable fractional exclusion rate would be applied; in each subsequent year, the percentage would be increased by 10 percent until the fractional exclusion rate became fully applicable.

The Treasury Department stated that the proposal to expand the investment interest limitation, which is described in Chapter 16.01 of volume 2 of the report, would continue to be effective for interest expense paid or incurred in taxable years beginning on or after January 1, 1986. The expanded investment interest limitation would continue to be phased in so that for taxable years beginning before January 1, 1988, interest subject to the limitation would be deductible to the extent of $10,000 plus net investment income, while for subsequent taxable years, the $10,000 threshold would be reduced to $5,000. The Treasury Department announced its intention to modify the phase-in of the expanded investment interest limitation in an additional respect. For taxable years beginning on or after January 1, 1986, an increasing percentage of interest expense that is treated as investment interest under the expanded definition but that is not subject to the investment interest limitation of current law would become subject to the proposed expanded investment interest limitation. That is, in 1986, 10 percent of newly limited investment interest (e.g., consumer interest, interest passed through a limited partnership or a passive subchapter S corporation) would be subject to the limitation; in 1987, 20 percent of newly limited investment interest would be subject to the limitation; in each subsequent year, the percentage would be increased by 10 percent until fully phased in. For purposes of the proposed limitation, the expanded definition of net investment income would be phased in on a similar basis.

The Treasury Department explained that the modified effective dates and transition rules for the proposals to index interest and limit investment interest deductions are intended to provide appropriate transition relief for persons who have previously incurred interest-bearing debt. The Treasury Department also stated its willingness to work with Congressional leaders and other interested parties to ensure that all other tax reform proposals contain rules which provide for fair and orderly transition.

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Chairman Rostenkowski. Thank you, Mr. Secretary. Mr. Secretary, we appreciate your comments with regard to providing some creativity concerning effective dates. We have also been concerned about the possible economic distortions caused by the mere presentation of the initial Treasury proposal.

Mr. Duncan and I have been studying this issue as well, and continue to have some concerns about retroactivity on the one hand and the potential for a "run-on-the-bank" syndrome developing, as some individuals and businesses try to beat the deadline.

Frankly, it is not clear to me that your statement dispels those concerns. We would like to analyze your effective statement to see whether further clarification is necessary to avoid uncertainty and disruption.

I would hope, Mr. Secretary, that you and your staff would assist us in this endeavor. I believe it has been the custom for the chairman of both the Senate Finance Committee and the Committee on Ways and Means and their ranking members to issue a statement or letter with respect to effective dates, so that there would be some certainty.

I hope that after we analyze your statement, we will be able to work with your staff so that we can endorse the principles of your statement, and leave enough room to prevent this so-called run-on-the-bank syndrome.

Secretary Baker. Mr. Chairman, we would be delighted to work with you, sir, and with the Finance Committee as well, to see if we can agree with respect to the specific transition rules.

Chairman Rostenkowski. Fine.

Mr. Secretary, advocates of tax reform have been concerned, and I have been, too, about the repeated inconsistencies of the administration since the Treasury proposal was first announced.

I hope that the administration will be firm in its assurance that all major tax expenditures remain on the table so at least the committee and the Treasury Department can begin their deliberations on an actual proposal.

We have had discussions on my side of the aisle and there is a strong feeling that the best way to begin is to have you join us in this long march for fundamental tax reform. I hope that we can expect that from the Treasury Department.

However, the administration's budget for fiscal year 1986 contains approximately $7.7 billion in new or extended tax expenditures, Mr. Secretary. Among them are enterprise zones, and tuition tax credits, and the extension of R&D credits.

How are these proposals consistent with fundamental tax reform?

Secretary Baker. Mr. Chairman, I thought that the dollar figure was somewhat less than that. Are you looking at it over a number of years, the 7.7, or is that——

Chairman Rostenkowski. A 3-year period.

Secretary Baker. Three years. Our position on that, Mr. Chairman, is that those items are provisions that are in the President's budget; they have been in prior budgets. They are proposals that the President continues to support.

I think we would have to agree with you that if we are going to have an overall overhaul of the tax system, we would have to look at those as well. But until we know that that is going to happen, those are initiatives that the President supports, and supports quite strongly.

The Treasury Department tax reform proposal, as you know, sir, is not a part of the President's budget. If we can reach the point with the Congress where it looks like there is a reasonable chance that we will get overall tax reform, clearly, we will have to look at all specific preferences, deductions, and other such items including these.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary.

Mr. Duncan will inquire.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. Secretary, I gather from your statement that it is your desire that all tax preferences, as the chairman says, be laid on the table and be examined to see what they do or do not do for the economy.

Secretary BAKER. Mr. Duncan, that is correct, with, I think, one limitation, and that is the one mentioned by the President in the State of the Union. The home mortgage interest deduction is not on the table as far as the President is concerned, but that is the only exception that I am aware of. We want to look at everything else that is dealt with in the Treasury plan; and, as far as I know, most everything else is dealt with, one way or the other, in the Treasury plan.

Mr. DUNCAN. Has any consideration been given to taking up separate parts of the proposal as opposed to considering all of it in one fell swoop?

Secretary BAKER. We considered that, Mr. Duncan, but we do not feel that that offers the best probability or possibility of success. As I said in my statement, we do not underestimate, for 1 minute, the magnitude of the task before us and we do not seek to minimize that in any way.

We do believe that if you try to do this piecemeal, you will never get to home base.

Mr. DUNCAN. I am aware that you might not be in a position to answer all the questions that we might desire to ask, but are you in a position today to indicate the possible percentage of error which your revenue estimators assigned to the revenue estimates under the proposal?

Secretary BAKER. No, sir, I am not. But just a minute, I may be able to answer that for you.

No, Mr. Duncan, I am not in a position to answer that. I will get you the answer to that, though.

[The following was subsequently received:]

INFORMATION REQUESTED BY MR. DUNCAN

You asked about the percentage errors associated with the Treasury Department's estimates of the revenue impacts of the tax simplification and reform proposals.

We believe our overall estimates of the revenue impact of the Treasury Department's set of tax reform and simplification proposals to be accurate within 5 or 6 percent. Some individual proposals in the set can be estimated with greater accuracy and others with lesser accuracy.

This is a judgement based on long-standing experience estimating government receipts. It is extremely difficult to specify the error associated with any one tax proposal or with a set of tax proposals, because there is no way to measure -- even after the fact -- how accurate the estimate was.

However, we do know the errors associated with our estimates of total tax receipts for the President's budget, since both the estimates and the actual receipts are published. These estimates include the effects of Administration proposals for tax law changes, and so provide some guidance on the accuracy of tax proposal estimates.

In 1981, an independent study on the accuracy of the Treasury Department's revenue estimates was published by the Congressional Budget Office. That study found that, for a 16-year period, 1963 through 1978, the total error associated with Treasury's individual income tax estimates was 6 percent. For corporation income tax estimates this error was 11 percent.

Once the Congressional Budget Office eliminated portions of these errors produced by substantive differences between proposed and subsequently enacted legislation and by differences between forecasted and actual economic performance, the remaining technical errors were ony 1 percent for both the individual income tax and the corporation income tax.

Mr. DUNCAN. Yes, sir.

One of the groups, I think, that most of us have been hearing from are the various charities. Could you indicate to us what kind of study has been made to find out what the impact would be upon charitable giving?

Secretary BAKER. We have an analysis on that and I will be delighted to obtain it for you, Mr. Duncan. I do not have it up here. I might say with respect to that provision as well as the others, as my statement indicated, we are listening to comments, complaints, suggestions for modification, and other facts that we receive from taxpayer groups, business groups, people interested in the charitable contribution deduction, and others.

I mean, we are receiving comments all the time and we are, quite frankly, factoring those into our consideration with respect to what we might ultimately be able to support. We realize that there is, as I understand it, a split between the charitable giving community with respect to which is more important, the ceiling we have put on there as the 2 percent of adjusted gross income, or the fact that we are calling for not allowing the appreciation in value of a security that is donated to charity.

We are receiving comments on all of those matters. I am not in a position to tell you today what our final recommendation would be.

Mr. DUNCAN. Thank you.

Secretary BAKER. May I say in that regard, because someone will ask this question—and I think it ought to be in the record even if somebody does not—it will be 4 to 6 weeks, Mr. Duncan, as I indicated to the chairman when he asked me to appear today, before we will be able to tell you specifically in what form we would want to indicate the President's specific views. Only then could I tell you whether we would want to come up here with detailed specifications, whether we would want to come up here with revisions to the current Treasury proposal in the same detail as the Treasury proposal now exists, or whether we would suggest coming up with specific statutory language.

Those are three alternative ways that we feel we could present the President's decision to you, but it will be 4 to 6 weeks before I will be in a position to tell you which of those three ways we think would be the best—consistent with the goal of getting tax reform enacted this year.

Mr. DUNCAN. But you still look at the Treasury proposal as the starting point?

Secretary BAKER. We still very much look at the Treasury proposal as a starting point. And, quite frankly, we are still in the process of doing that. We are having intradepartmental meetings quite frequently. I will be discussing the Treasury proposal and other proposals with relevant members of the jurisdictional committees here on the Hill, with congressional authors, and others.

Again, I might say for the record that we have not had any such discussions as yet, with two exceptions. We have had discussions with Senator Packwood and we have had discussions with Chairman Rostenkowski. Except for those discussions, we have not had discussions outside of the Department.

Mr. DUNCAN. Thank you, Mr. Secretary, and thank you, Mr. Chairman.

[The following was subsequently received:]

[illegible]

Congress of the United States
House of Representatives
Washington, DC 20515

Ranking Minority Memb
JOINT COMMITTEE
ON TAXATION

March 5, 1985

Honorable James A. Baker, III
Secretary
Department of the Treasury
15th St. and Pennsylvania Ave., N.W.
Washington, D.C. 20220

Dear Mr. Secretary:

I appreciate your coming by my office after you presented your testimony on the tax reform proposal to the Ways and Means Committee. I look forward to a cooperative and rwarding relationship with you and your staff in the coming years.

During the hearing I did not have an opportunity to ask all of the questions I planned on asking. I would appreciate it if you could provide responses to the attached questions concerning the mining industry.

Thank you for your time and attention to this matter. I look forward to working with you in the future.

Sincerely,

JOHN J. DUNCAN
Member of Congress

JJD/pw

Mr. Secretary,

I would like to raise some questions concerning the potential impact the Treasury's tax proposal would have on domestic mining operations. This industry has not experienced any notable effect from the economic recovery, and its employment in some sectors remains at about half the level it was just three or four years ago.

Because almost all products used by society originate with the natural resource industry, it seems worthwhile to explore with you the potential impact the Treasury proposal would have on domestic mining operations.

1) Do you agree, Mr. Secretary, that mineral exploration and development is uniquely risky?

Because the location of economically recoverable minerals is not a matter of human choice, isn't it fair to say that the mining industry also requires extraordinary expenditures for related infrastructure and specialized handling and transportation facilities?

2) Isn't the basic mineral industry also extremely capital intensive due to the special need for increasingly large and expensive extraction and processing equipment for modern economy-of-scale operations?

(It's no secret that foreign governments are aware of the importance of mining and are participating, directly and indirectly, in mineral development and exploitation.)

3) In view of the points I've just raised with you, Mr. Secretary, I question why there would be any private investment at all in mining under the Treasury proposal, and I wonder how this so-called reliance on free market forces is in the best interests of the United States under today's world circumstances. Would you comment on this?

I agree that, unfortunately, much of the domestic mining industry has been subject to a prolonged downturn in profits due, in large part, to low prices (occasioned by reduced demand and world oversupply) and a highly valued dollar. It is also true that mineral deposits are not uniformly distributed throughout the world. However, I cannot fully subscribe to the proposition that all mineral exploration is inherently risky nor that mining is extremely capital intensive when compared with other industrial activities. Accordingly, it is not altogether clear that the present law tax preferences vis-a-vis other business activities should be maintained. However, Treasury is aware of the current condition of the mining industry, and I can assure you that we are taking this into consideration as we review our proposals.

Chairman ROSTENKOWSKI. Mr. Gibbons will inquire.

Mr. GIBBONS. Mr. Secretary, I want to first congratulate you for the fine appearance that you are making, and I say that with a great deal of feeling. I have been sitting here 16 years listening to Secretaries, and you come as close to outlining my views as any Secretary of Treasury ever has.

I would hope that we can work together, and I would give you some benefit of my 16 years on this committee. We need specific legislative language from you. The great power and prestige of the Presidency will go a long way in calming some of the fears and some of the infighting that must necessarily take place when we mark up a bill.

So, I suggest to you that you bring in specific legislative language because I want a tax reform bill and I think it would make it far easier to pass, far more certain of passage, than just an outline of some proposals and principles.

I do not think that many of us disagree too deeply with the principles that you have enunciated here. I do have one concern, though, and I want to ask you a question about that. There is a great deal of change in the condition of America from 16 years ago.

Foreign trade was a very small part of the GNP of this country 16 years ago. The whole imports and exports were less than $50 billion. Now, they are approaching $600 billion, and growing very rapidly; 16 years ago, we had favorable balances of trade from this country on merchandise; today, we do not.

I have blamed a lot of it on the overvalued dollar, and I have blamed a lot of that on the fiscal deficit that we are running. But I think the causes are far deeper than that and the solutions are going to be far tougher to come by.

American industry and farms and factories must compete in a world economy now, and I do not believe the original Treasury proposal thoroughly understands that situation. I think it would leave America's farms and factories and America's workers at a disadvantage when we look at the rest of the world tax picture.

And I hope that in the restructuring of your tax package, you will take that into consideration. Have you all considered that?

Secretary BAKER. Yes, sir, we have, and we will be doing so. We are concerned, as you are, about the trade deficit. As I said during the course of my confirmation hearings. Mr. Gibbons, We want to take a look at every provision of this proposal that might adversely impact capital formation, incentives for investment, savings, and the like, and we intend to do that and are, in fact, doing so.

Mr. GIBBONS. Now, I realize that occasionally newspaper reports can be wrong, and my source of this is a newspaper report that I read in my local newspaper. You appeared before the Budget Committee last week and you were quoted in my local newspaper as having said that the President would veto the present proposal if it came to him in that form. Is that correct?

Secretary BAKER. No, sir, I did not say he would veto it. They asked me if he would sign it and I said I did not think so, and here is why. If the President would sign the Treasury proposal, I do not think that he would have said what he said in the State of the Union about working with the Congress to fashion a bipartisan tax reform plan. I do not think he would have commissioned me to go out and do what he has commissioned me to go out and do.

The point I was making is that there are provisions in that Treasury proposal, I think, that ultimately he would find unacceptable.

Mr. GIBBONS. Now, we have Bradley-Gephardt; we have Kemp-Kasten; we have a number of other proposals that are pending here. In fact, Mr. Rangel has introduced the Treasury proposal.

Do you support any of them?

Secretary BAKER. Do we support any of them?

Mr. GIBBONS. Yes, sir.

Secretary BAKER. We do not at this stage support any of them as written, no, sir. We want to work with the Congress and see if we can come up with a proposal that accomplishes the principles I have set forth in my statement and that has broad bipartisan support.

Mr. GIBBONS. Now, 4 years ago, your predecessor sat here in the same position; both of us sat in the same position. And he espoused to this committee that we just had to have accelerated cost recovery and we had to have investment tax credit.

That same Secretary in November said we did not need them anymore; we should not have them anymore. Where does the present Secretary stand on that issue?

Secretary BAKER. The present Secretary stands on that issue where he stands on each and every other element of the Treasury plan, Mr. Gibbons, and that is that we are going to take a close look at it. [Laughter.]

Mr. GIBBONS. That is helpful.

Secretary BAKER. I have got to say that I told the chairman when he asked me to come this morning—I said, you know, if you want to get into the specifics of each and every item of the Treasury plan, we are not going to be ready. And the chairman said that is all right; we need to start talking about principles and we need to make clear to the American people that there is strong support in the Congress and, quite frankly, strong support on the part of the President of the United States for an overall tax reform bill.

Mr. GIBBONS. Mr. Chairman, my time is expired and I shall not transgress any further. I have some written questions that I will send to the Secretary.

Secretary BAKER. Sure, absolutely.

Mr. GIBBONS. If that is permissible, we can include them in the record?

Chairman ROSTENKOWSKI. Without objection, so ordered.

QUESTION. Approximately 30 million American households rent.

In 1983, the median renter-household income was under $14,500. The Treasury Tax proposal would repeal many tax incentives to attract investment to housing.

Has the Treasury Department analyzed the impact of its proposal on the construction of multifamily housing, the supply of rental housing, and rent levels in the short term and future?

If so, what are the results?

If not, please conduct such a study.

Request for information on how the proposal would change the cost of owning versus renting a home.

The Treasury Department has not done a formal study of the effect on rental and owner-occupied housing of the tax reform proposal. I can refer you to an excellent overview article by Anthony Downs that discusses the various ways in which a fundamental restructuring of the income tax system would impact on the real estate market: "Impacts of the President's Proposed Tax Reforms upon Real Estate," Urban Land, August 1985, pp. 7-14.

The Downs article concludes that under the proposed tax reform rules "a higher proportion of those households facing the rent-or-buy decision is likely to choose homeownership." The article states that Treasury II would take away many of the tax benefits enacted in 1981 which made rental housing and other investments more profitable than they had been and "would gradually put upward pressure on rents, thus tilting the balance of attractiveness back toward homeownership." In discussing the potential increase in rents, the article states that "adoption of Treasury II would reduce the profitability of typical individual projects somewhat, but that these losses could be offset by relatively modest increases in future rents. Of course, in heavily over-built markets rents cannot easily be increased even modestly."

We are familiar with several other studies that have simulated the long-run effect on required rents resulting from tax reform. These models generalize from a single rental project to the entire rental market, thus neglecting a number of factors discussed in the Downs article. The simulations also are highly dependent on a number of questionable assumptions. The most important assumption is that additional investment in rental housing is done solely by investors in the top 50 percent tax bracket. The reduction in the top rate from 50 percent to 35 percent accounts for approximately one-half of the increase in required rents in these simulations. [Note: for businesses generating taxable profits a reduction in tax rates would lower costs and enable a reduction in prices.] The table below shows that, contrary to the assumptions of these studies, rental income is distributed widely among taxpayers with marginal tax rates below the top personal rates.

Number of Individual Tax Returns Reporting Rental Income/Loss on Schedule E in 1983

Marginal tax rate	Number of returns (000's)	Percent
Zero	947.2	11.8%
1-14.9	632.7	7.9
15-19.9	2,133.7	26.6
20-24.9	864.5	10.8
25-29.9	929.7	11.6
30-34.9	708.3	8.8
35-39.9	717.4	9.0
40-44.9	693.9	8.7
45-48.9	152.0	1.9
49+	228.3	2.9
Total	8,007.8	100.0%

Source: 1983 Statistics of Income Individual Income Tax Returns

Office of Tax Analysis
Department of the Treasury

September 10, 1985

Chairman ROSTENKOWSKI. Mr. Secretary, I am sure that we will run overtime with each questioner. Therefore, I suggest that if they do send questions in writing to the Department, that they be answered as quickly as possible.

Secretary BAKER. Sure.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Secretary, it is good to have you here this morning and you have made a good statement; we appreciate it.

Now, I know we are talking about principles, but that does not mean much bread and butter. I am going to try to be a little more specific, if I can, with you. This is pleasant to be engaged in a little waltzing contest here, but I think we have got to go beyond this Alphonse and Gaston act and see if we cannot get down to a few specifics. [Laughter.]

Am I to understand that you are going to have a proposal up here within 4 to 6 weeks?

Secretary BAKER. Within 4 to 6 weeks, Mr. Pickle, we will be in a position to tell you the form in which our proposal will come.

Mr. PICKLE. That is not enough, Mr. Secretary. We have a form now and I cannot take that home with me or sell it to the public. Within 4 to 6 weeks, will we have a proposal from you that will be the President's proposal?

Secretary BAKER. You will have a proposal shortly after the expiration of that 4-to 6-week period, yes, sir.

Mr. PICKLE. Well, now, Mr. Secretary, if that is the case, this is February; then we go through March and that means we are into the Easter recess. That means for all purposes that we will not go to work, really, until, say, May 1. Is that about right?

Secretary BAKER. That is about right, yes, sir.

Mr. PICKLE. Well, that is disconcerting to me. Now, let us get down to some more specifics. With respect to nontaxpayers, a recent IRS report disclosed that 299 individual taxpayers who had incomes of in excess of $150,000 in 1983 paid no taxes for that year.

And, as I understand it, the statistics are equally alarming for profitable corporations. Will the Treasury's proposal ensure that wealthy individuals and profitable corporations would pay some taxes?

Secretary **BAKER**. Well, it is those types of vices, Mr. Pickle, that we seek to address in the Treasury proposal and that we would seek to address in tax reform. Now, I am sorry to say I cannot tell you with respect to the individual whether the current Treasury proposal would address that, but I can tell you that if it does not, it should.

That is why, quite frankly, we need a little time to review these things in detail and come up here with a package that makes sense and that can gain bipartisan support.

Mr. **PICKLE**. Am I to understand, then, that you are saying that it would be well to have some kind of a mechanism in our tax system that would guarantee that no wealthy taxpayer or profitable corporation could just zero out their taxes?

Is that the principle that we are in general agreement on?

Secretary **BAKER**. Yes, sir, and if you are moving to a minimum tax—let me say this: People have said, would you support a minimum tax, and the answer is at this stage, no, we would not. But, hopefully, tax reform will get rid of the need for a minimum tax. If we accomplish tax reform in the right way, we will, in effect, have one.

Mr. **PICKLE**. Well, that is always to be hoped, Mr. Secretary, but we have got a minimum tax now and we still have those who ought to pay but are not paying taxes. And I do not know that this phantom bill that you and the President talk about gives us that mechanism. We may have to consider some way for fairness if we want fairness, so I think we may have to consider that.

Now, on the charitable giving area, I think that the American people are motivated to give for charitable purposes, in part, because of the tax incentives available. Regardless of any tax proposal that moves forward, would the administration support a meaningful charitable incentive that would encourage giving from all income sectors?

I guess what I am specifically asking is will any tax bill you propose allow incentives for charitable contributions? I know it is in the Treasury proposal. Will you have some flexibility between the 2 percent, say to lower it to 1 percent or to develop some other modification?

Secretary **BAKER**. Yes, sir. We do not want to destroy charitable giving in this country. We want to see that continue. I would suggest, Mr. Pickle, if I might, that the mere reduction of rates is going to be some incentive for additional giving. I cannot measure that for you, but yes, we want to see charitable giving continue and we do not want to see that destroyed.

Mr. **PICKLE**. Well, it is almost as much a fundamental part of any tax reform proposal as, say, the deduction for home mortgage interest. Some way, we have got to retain that in this bill. Is that your general approach?

Secretary **Baker**. Well, the President has taken a specific position on home mortgage interest; we have not yet on charitable—you asked me if there is room to talk in there, and the answer is: yes, sir, there certainly is.

Mr. **Pickle**. Now, I want to ask you one other question because I know my time is running. The administration tax plan proposes that percentage depletion and expensing of intangible drilling costs would be repealed. That is of some concern for my State, and for all of the oil and gas producers in the country.

Do you believe the loss of intangible drilling costs and percentage depletion would have a serious effect on the domestic exploration and drilling activities of this country?

Secretary **Baker**. We are in the process of trying to accumulate information on that now, Mr. Pickle. We are seeing representatives from the energy industry on an almost daily basis, as I am sure you are and other people are—both in the executive and legislative branch.

I think we need to determine the extent to which that would be the fact. I said in my Senate confirmation testimony that I feel strongly that we need a viable domestic energy industry in this country as a matter of national security. That is what I personally believe.

I cannot tell you yet the extent to which the Treasury proposal would result in fewer wells or anything like that.

Mr. **Pickle**. Well, if you believe that strongly enough, we might include oil and gas incentives as one of the exemptions along with home mortgage interest deductions because it is that important. [Laughter.]

But, Mr. Secretary, I submit to you that the loss of the depletion allowance and intangible drilling costs would have a very negative, if not disastrous, effect on this country. And I would hope you would give us some leadership instead of saying you are going to take those incentives away.

I have some additional questions. I hope I can come back.

Chairman **Rostenkowski**. I am sure Mr. Archer would like to carry on that conversation on depletion. [Laughter.]

Mr. **Archer**. Thank you, Mr. Chairman.

I do not intend to get into any specific questions, Mr. Secretary, because we will have plenty of time for that as we go along. I applaud the administration for launching us on this effort of broad-based tax reform.

I think there are a couple of yellow lights, caution lights, that should be considered, some of which have already been touched upon. One is that fundamental tax reform, viewed in isolation, without considering its impact on the major threads that are woven into our economic fabric, could, I think, lead to a possible pyrrhic victory.

And I think we need to be very, very concerned about what the economic impact is going to be and not be just hung out on the concept of academic tax reform. In major areas—I think some have already been mentioned; that is, capital formation and savings and jobs and, as the chairman of our trade subcommittee mentioned, a concern for foreign competition and the ability of our people to compete in the foreign market—there are different rules out there than there are domestically.

And to think in terms of tax reform as having symmetry both domestically and in the foreign marketplace could very well destroy to a greater extent our ability to compete, and that mean jobs. Capital formation, capital savings, means jobs.

In addition, another major thread that is woven into our economic fabric which I think we have got to be careful that we do not destroy is shelter, the provision of shelter for the people in this country; and, lastly, energy, which my colleague from Texas, Mr. Pickle, treated.

Another caution light is related to the transition rules and to retroactivity, and what that might do to economic decisions right now. And I am pleased that you have taken the position that you have taken. I hope that both the chairman of our committee and the chairman of the Senate Finance Committee will pin down as much as possible the type of grandfathering and transitional rules and effective dates that we are going to be dealing with so that we can move ahead with decisions.

And along that line, I would like to ask you your opinion, because I do not think this is necessarily a specific tax question, but rather relative to transition, on how you would feel about treating limited partnerships that were created this year. I would assume you would have no objection to their being taken care of under the current law and not in any way be confronted with changes that might result from our tax exercise.

Secretary BAKER. The Treasury proposal has a 5-year phase-in now with respect to the provision that would tax limited partnerships of over 35 as corporations.

Mr. ARCHER. So, in other words, even if a partnership were created today, under the existing law, partners could not be sure that they would be able to continue with their specific operation for which the partnership was created without changes in the tax provisions that would impact on them in the future?

Secretary BAKER. That is correct.

Mr. ARCHER. I think that is a serious deterrent to the use of this tool in our economic activities.

Chairman ROSTENKOWSKI. Will the gentleman yield?

Mr. ARCHER. I will be happy to yield.

Chairman ROSTENKOWSKI. Mr. Secretary, this is what I referred to with respect to your proposed effective dates. I think that we should analyze your statement and have our staff work with your staff to develop a possibile statement or letter signed by the chairman of the Ways and Means Committee and the Finance Committee and the ranking members. I think that is where my concern is.

Secretary BAKER. Mr. Chairman, I quite understand that. In announcing the January 1, 1986, effective date as we have done this morning, I do not for 1 minute suggest that that cures all problems. But it sure cures a heck of a lot of them, in terms of investment decisions that might have been on hold for the balance of this year—at least so far as entities currently in existence are concerned.

Chairman ROSTENKOWSKI. Mr. Secretary, I have no quarrel with trying to give the business community some degree of certainty. The question is whether we see runs develop.

Secretary BAKER. I understand your concerns on the other side of that equation.

Chairman ROSTENKOWSKI. Mr. Archer, you may continue.

Mr. ARCHER. Mr. Chairman, if I might have a reprieve for 30 seconds or so of my time, I only have a couple of other quick points. On this question of retroactivity, would it be acceptable to the Treasury that any project that is created this year would be covered under the ACRS and the investment tax credit of the current law and be able to keep that throughout the life of that particular project?

Secretary BAKER. Yes; I am told the only limitation on that, Mr. Archer, is that the projects have to be placed in service in order to, in effect, be grandfathered in.

Mr. ARCHER. And I hope we have not muddied the water rather than helping in this area because I think it is extremely important that we continue with the economic decisions in the marketplace this year and not have them shut off for fear that we might somehow clamp down on them and prevent them from being able to operate under the Tax Code under which they are formed.

Thank you very much.

Chairman ROSTENKOWSKI. Mr. Stark will inquire.

Mr. STARK. Thank you, Mr. Chairman.

Mr. Secretary, it is obvious from your discussion this morning that you probably are one of the most highly principled members of the executive department to come before this committee in recent years, and it is equally obvious that your foremost principle is flexibility. [Laughter.]

I always find that to be an admirable feature, but I do have a question, in all seriousness.

Last year's Deficit Reduction Act resulted in a complete overhaul of the taxation system for the life insurance industry. It was done with the complete cooperation of your department's staff and with their concurrence in a complete revision of the way we tax not only life insurance companies, but the policies.

I would be perfectly willing to agree with you if, as part of a broad-based reform, you felt it was necessary to revisit those regulations and laws that are a result of last year's work, and particularly if we are going to level the playing field and if we are going to take care of banks and casualty and property companies, and all the other things that are not now contributing revenue, when we have already raised the revenue that the life insurance industry is contributing.

Would it not seem fair as a matter of priority to suggest to the several hundred thousand life insurance agents and the thousands of companies and the millions of policyholders whose complete financial structure is now sort of hanging in the balance wondering whether we are going to change the road rules once again, to say or to agree with me—and I know Congressman Moore on the minority side agrees—that we ought to look at all the other possibilities for raising revenue or restructuring or making the code more fair and let the life insurance industry proceed and get about its business under the rules that we all agreed, on a bipartisan executive and legislative branch agreement last year, were fair?

I am not asking you to say we will not touch it, but what I am basically asking you to say is how about let us get after some of the corporations that are zeroing out and some of the egregious shelters and send a message to the life insurance industry that they gave at the office last week and we have got some other places to raise money first.

Mr. Moore. Will the gentleman yield?

Mr. Stark. I would be glad to yield to my colleague.

Mr. Moore. Before the Secretary answers the question, I would simply like to join with my distinguished colleague from California very strongly that this was legislation passed last year that was worked out over the course of a year-and-a-half with the industry and the Treasury Department in full agreement, to my knowledge.

I am not aware of anything that the Treasury Department disagreed with in what was done. We have created a total tax overhaul of an industry that now is trying to operate under those rules, and there is somewhat of a chaotic situation being cast now with the prospects of changing it.

It may be we have to go back and revisit that area if, in changing the tax law of other competing kinds of industries, we have an uneven playing field and have to go back and readdress life insurance taxation to make it an even playing field.

But I would strongly join in with my colleague from California, asking that absent that, we really not get back into this area.

Secretary Baker. Mr. Stark, I do not see how we can take one industry and write it out, even though I recognize that the matter was done on a bipartisan basis with the concurrence of the administration.

Mr. Stark. I would not suggest writing it out, Mr. Secretary, for a minute. I just think it would put them at the bottom of the pile and get at some of the tougher problems first.

Secretary Baker. We are not elevating them to the top of the pile. In fact, in answer to an earlier question, I said I did not think we could go at this thing piecemeal. Mr. Duncan, I think, asked me, could we not just do part of this. I do not think you can; I think you have got to take the whole package at one time.

Mr. Stark. Mr. Secretary, if I could convince you and your staff that the way the legislation was designed last year made it so flexible and so adjustable that we could meet the tenets of your proposal in terms of fairness and equity by merely adjusting rates at some point to have it fit in with an overall package, might you be willing to listen to that kind of an agreement and then say we will visit the other areas first?

Secretary Baker. Well, we would certainly listen to any proposal that you submit, yes, sir. I cannot agree to it today, obviously.

Mr. Stark. Thank you for your indulgence.

Secretary Baker. But let me say one final thing. We do not intend to leave out corporations that are, as you say, zeroing out. I mean, that is an integral part of this effort.

Mr. Stark. It is just a question, Mr. Secretary, of time. To do these things with your staff and our staffs, we are going to have to have some sense of priority of who we tackle first.

We have already said we are going to leave the homeowner's interest deduction alone, for whatever reason. I have not much interest in answering 200,000 letters from life insurance agents. I will be glad to send them over to Mr. Pearlman to respond to for me.

I think the point is that it is important because this is such a vital financial industry that redesigned its products. It really went through a wrenching turmoil and now we are sort of putting them on hold, not knowing what they can do.

I think it is important that you, sir, send them some kind of a signal, and we would like to cooperate in helping you with that, but I think it is urgent for the industry.

Thank you.

Chairman ROSTENKOWSKI. Mr. Jones will inquire.

Mr. JONES. Thank you, Mr. Chairman.

Mr. Secretary, I want to join my colleagues in commending you on a very fine presentation today. I want to explore the area of capital formation. As I read the Treasury proposal, essentially you are pitting simplicity and tax cuts for individuals versus the whole area of capital formation, where the cost of capital will go up in order to finance tax cuts for individuals.

I question whether or not that is good policy, particularly as I read the totality of your business tax proposals in the capital area. The cost for the recovery of capital will be disadvantaged in the United States in relation to the recovery of capital in virtually every other competing industrial country.

I think some serious consideration needs to be given to that fact and to whether or not there would be a tendency or an incentive to locate our manufacturing base offshore, making the United States, basically, a service and a marketing economy. I do not think that would necessarily be good.

For example, the present ACRS and the ITC together approximate expensing. The totality of the Treasury proposal would reduce that to about 78 percent or so of expensing. It would cost ten percent or more in the recovery of capital.

My question is, have you thought about what percent of expensing our tax laws should be? Have you given any thought to that?

Secretary BAKER. We do not have any arbitrary figure, Mr. Jones. As you well know, this is the area that has attracted the most comment and the most interest from people who would be impacted by the Treasury proposal. We have heard, I suppose, more from people who are interested in ACRS and ITC than any other single group.

I can only repeat for you what I have said in prior testimony, and that is that we want to look at each and every one of these proposals to make certain that we do not do something here that would seriously adversely affect capital formation in this country.

We do not want to put ourselves in the position of being even more noncompetitive overseas. At the same time, if we are going to reform the Tax Code, if we are going to make it more fair and more simple, we are going to have to take a look at the preferences and deductions that now exist in the current law.

Mr. JONES. Well, I would agree with that. But when you look at incentives such as the ITC or lower rates for capital gains taxes, every time those incentives have been taken away, capital formation has dropped, whether it is venture capital or in equipment, et cetera.

Every time those incentives have been restored, there has been economic activity. It just seems to me that we ought to be very cautious about that.

Secretary **Baker**. I agree, we ought to be cautious, but I do think that there is a balancing of interests and a balancing of equities that is required here.

Mr. **Jones**. Well, I might suggest we may want to approach this slowly, particularly if we get into a time bind that is brought on by the schedule that you outlined to Mr. Pickle. We may want to look at simplicity and reform and cuts for individuals, and take a longer look at the whole business tax area; perhaps adopt something similar to what Messrs. Stark and Chafee have recommended to raise taxes in the business area.

I wanted to get secondly into an area of a more parochial interest, but it also has a national implication—that is in oil and gas. Virtually every incentive for capital in oil and gas drilling has been eliminated by the Treasury proposal.

The Department of Energy a couple of weeks ago testified that you cannot put the domestic energy industry on a level playing field and hope to let it survive. A month ago, the Interstate Oil Compact Commission presented to the Treasury what they would anticipate the decline in the domestic oil and gas industry would be if the Treasury proposals were adopted.

My question to you is: First, do you disagree with the Energy Department's assessment about the level playing field? Second, do you disagree with the statistics that the Interstate Oil Compact Commission presented to the Treasury over 1 month ago, and if so, in what way and how?

Secretary **Baker**. I cannot answer the latter part of the question, but I will get you an answer to it. I do know that those statistics were given to our people and that they have been analyzing them.

As far as the level playing field is concerned, Mr. Jones, the only thing I can say is, again, what I have said before—that I do think you have got to give some consideration to risk when you are making determinations such as this.

I think, quite frankly, more importantly than that, you have got to give consideration to the national security aspects of this question. I am aware of the Energy Department's views. Those views are going to be made known not only over at the Treasury Department, but across the street as well. That is what I meant when I answered Mr. Pickle's question by saying that we have got to weigh the national security concern in reviewing the current Treasury proposal. And I am sorry I cannot be any more definitive than that, but this is not the time.

[The following was subsequently received:]

Treasury's Response to Mr. Jones

The Interstate Oil Compact Commission [IOCC] has submitted three studies to Treasury on the impact of Treasury's tax reform proposal on domestic oil and gas production. While we agree with the basic conclusion of these studies, that the tax reform proposal would result in some reduction in domestic energy production, we do not agree with the studies' specific conclusions on the more difficult question of the magnitude and duration of the anticipated decline.

The first IOCC study examined the impact of the repeal of percentage depletion on stripper oil wells. However, this study assumed that the operators are in a 50 percent tax bracket, thus totally ignoring Treasury's proposed reduction in corporate and individual tax rates. The second study submitted to Treasury by the IOCC dealt with Treasury's proposed repeal of the expensing of intangible drilling costs [IDCs]. The study's results follow from the assumption (rather than the demonstration) that industry expenditures will be reduced by one-third and third party funding by one-half as a result of Treasury's proposals. The third IOCC study dealt with the effect of the proposed repeal of the expensing of qualified tertiary injectant expenses and aspects of Treasury's proposal on enhanced oil recovery. No analysis has been provided Treasury, and thus we cannot adequately evaluate this study.

As I have noted in my testimony, Treasury is concerned about the uncertainty and dislocation which might result from too rapid a transition from the existing tax system to a new tax system. For this reason we are considering possible modifications to the transition rules originally proposed, as well as reviewing all of our proposals to make sure that they are as consistent as possible with the President's goals for tax reform.

Chairman **Rostenkowski**. Mr. Gradison will inquire.

Mr. **Gradison**. Thank you, Mr. Chairman.

Mr. Secretary, I want to congratulate you on a very powerful statement in support of tax reform. I am sure you know that this inevitably will be an uphill fight. From what I can see, the potential winners are skeptical that the Government is going to do anything to help them, and the potential losers are organizing.

Millions of dollars are being raised and spent to influence our decisions and to try to protect the special interests that are built into the Tax Code today. Historical experience says to me never bet on comprehensive tax reform, but experience also says never, never bet against Ronald Reagan.

I think this venture can only succeed with Presidential leadership. I understand your statement that you have no deadline for submission of an administration proposal. As a member who wants tax reform to succeed, I want to stress two things and ask your comments on them.

First, the urgency of receiving the administration's recommendations so that we have a shot at action this year; efforts to stop comprehensive reform are well financed and well underway. The longer it takes you, the more time opponents have to line up support here on Capitol Hill, and they are working every day to do that.

Second, we need highly specific recommendations, not just general principles, when you complete your review of the Treasury plan, and we need the President's name behind those.

Secretary **Baker**. Mr. Gradison, in whatever form we choose, there will be specificity. I do not think you have to worry about that. Furthermore, regardless of the form in which we make known to you the President's decisions, you are going to have him leading the charge.

I mean, you talk about Presidential leadership. If you listened to the State of the Union, I think you saw that the No. 1 item that he mentioned in there was comprehensive reform of the tax system. So I do not think anybody should doubt for one moment the President's commitment to this. If he was not committed, he would not have said what he did in the State of the Union. I would not be here today, as a matter of fact.

Mr. **Gradison**. Thank you, Mr. Secretary. Let me say one other thing. I have heard some talk about the possibility of a bipartisan commission or something modeled after the Social Security reform efforts.

I would like to just suggest a word of caution about considering that approach. In that instance, there is no question that the commission did an outstanding job and that the Congress essentially approved what the commission recommended with no substantive changes, but there was an action-forcing event.

The checks were not going to go out on time in mid-1983 if we did not have a plan. I am genuinely concerned that if we do not work through the difficult and slow but normal process here that we could end up with a plan that just gathered dust on the shelves because I do not see anything to force action on it.

I just want to offer that commentary on our recent history. Thank you, Mr. Secretary.

Secretary **Baker**. May I just respond to that so you know where we are coming from on that, if I might?

Our position on a bipartisan commission is simply that we ought not to rule that out as a vehicle or a means or a way to get there. What we want to do is accomplish tax reform, and we want to do it this year. And we just simply do not think we ought to rule out any possible way of getting there.

I am well aware of the difference that exists between this situation and the Social Security compromise and the private deliberations we had leading up to that legislation. But all I am simply saying, I hope, is that we do not want to rule that out as a way to go if it is a possibility. I am, furthermore, well aware of the chairman's aversion to that approach.

Chairman **Rostenkowski**. Mr. Pease will inquire.

Mr. **Pease**. Thank you very much, Mr. Chairman.

Mr. Secretary, I am delighted to have you here today. I would like, first of all, to associate myself with the concerns and remarks of Mr. Gradison, and I am delighted to hear you say that you will have very specific proposals for us in due course, and that you do expect the President to lend his full time and effort and prestige to the effort.

If that is the case, I, for one, am optimistic that we can achieve tax reform this year. I am particularly interested in your comments about the Tax Code being neutral as to types of investment. I would agree with that.

I have been concerned for some time that the Tax Code not encourage American companies to locate facilities overseas, and in that regard the deferral of taxes earned by subsidiaries of American companies overseas is of some concern to me.

Are you prepared at this time to make any comments specifically about what the Treasury will recommend or may recommend in terms of tax deferral until profits are repatriated to the United States?

Secretary **Baker**. Well, I think the Treasury proposal addresses that. I am not prepared at this time, just as I am not prepared with respect to any other item, to come down definitely for or against, with respect to a certain modification, because I ought not to be doing that today, quite frankly, Mr. Pease. But I do think that is a problem that is addressed by the Treasury proposal.

Mr. PEASE. I gather, then, that at least in principle you would agree that we ought to make sure that there is neutrality and that American tax law does not encourage investment overseas?

Secretary BAKER. Yes, sir. As my statement indicated, Mr. Pease, absent compelling reasons to the contrary, we think that we should make it as economically neutral as we can. Obviously, I suppose we could never achieve absolute economic neutrality, so there are going to be some exceptions.

Mr. PEASE. Let me ask you a question on home mortgage interest. You said that that is one thing that is not on the table. Does that mean that the President would insist that the law remain as it is currently on home mortgage interest?

At one point, I think you referred to protecting the home mortgage interest deduction for homeowners for their primary residence. Is there a distinction that needs to be drawn?

Secretary BAKER. Again, without saying this is the final word, Mr. Pease, I think there is a distinction and I think that when the President made that commitment a year-and-a-half ago, he was talking about the primary home.

Mr. PEASE. Looking at provisions for depreciation, you have said, I think, that the proposals ought to be neutral and we ought not to skew investments. One present Tax Code provision that does encourage investment one way or another is ACRS.

You have also heard some concern expressed by the committee today that the new provisions not put the United States at a disadvantage in terms of investing in new plant and machinery with our competitors overseas.

Can you assign a weight at the present time to which of those two considerations would be most appropriate?

Secretary BAKER. No, sir, I cannot assign a weight at the present time, but that is a good example of the balancing of equities that is going to be required here with respect to a lot of these provisions.

You know, it may well be that economic neutrality is just simply not consistent with the idea that we do not want our businesses going offshore.

Mr. PEASE. I am concerned also about the distributional effects of tax reform. You said in your testimony that one principle of your plan is that we not affect the distribution of the current tax burden.

Is it your feeling that the current Treasury proposal does not shift the burden from one income group to another, and that the proposal you finally will give us in April or May will not do so?

Secretary BAKER. Yes. The current Treasury proposal does not, and I feel reasonably certain that the proposal we give you will not.

Mr. PEASE. Thank you.

Secretary BAKER. As I hope my statement indicated, we do not think we ought to get caught up in a debate about redistribution of the tax burden.

Mr. PEASE. Mr. Secretary, your statement this morning and your comments thus far have been very, very encouraging, and I wish you well. We are happy to work with you.

Secretary BAKER. Thank you.

Chairman ROSTENKOWSKI. Mr. Matsui will inquire.

Mr. **Matsui**. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for presenting your testimony today. I would like to, if I may, just refer back to page 3 of your testimony and refer to the five principles set forth in your testimony.

One, you indicated tax reform will not result in an overall tax increase or additional revenues to the Federal Treasury. Two you intend to protect the home mortgage interest deduction because the President in Texas some time ago during the campaign indicated support for that.

Three, you will maintain a rate for individuals and corporations no higher than 35 percent from its current level. Four, you will not affect incentives for capital formation. And, five, those individuals living at or near the poverty level will be exempt from taxation, and that is an issue Mr. Rangel, Mr. Ford and I have been interested in.

Mr. McClure had testified last year before our subcommittee on that issue and we were very interested in that provision, but all five of them are very important to all of us. And I think the general principles are all desirable and obviously laudable.

My concern is that we are not snookering the American public because I remember back in 1981 when the President gave a speech on national television just before the tax bill that he won on the floor of the House that he was going to, in fact, decrease taxes significantly—$750 billion over a 5-year period.

He was going to, which he did, increase defense some 35 percent in real terms over the 4-year period of his tenure. And at the same time, he promised us that he was going to balance the Federal budget.

Now, of course, we all know that he has performed two of those admirably, but did not perform the third. In fact, I think John Anderson's statement about smoke and mirrors is more true today than it was in 1980 when he made that statement.

My concern is that you are going to present this to the American public, these five goals, and everybody is going to be winners after today because it will be viewed on television and everybody is going to say the rates are going down; we are not going to affect capital formation. So, therefore, we are all going to get behind tax reform.

The fear I have is that you are going to let one or two of these goals go during the process of this year. I certainly hope that it will not be for the people at the low income level, but that is just my desire. I do not know what yours is and I do not know what the President's is and I do not know what the balance of the members on the Senate Finance Committee and the House Ways and Means Committee are.

Do you really honestly believe that the President will achieve these five goals at this time, which I relate back to the 1981 comments he made on television?

Secretary **Baker**. Well, we sure hope so. Again, I do not think we would be going through this exercise if we did not think that there was a reasonable chance of success. I have got to repeat what I said earlier that we do not underestimate the difficulty of the task. We do not seek to minimize it in any way.

This is a major, major undertaking, but I do not think the President would have highlighted it the way he did in his State of the

Union, nor have been as specific as he was, had he not felt that there was some reasonable chance of success.

What happens if we do not meet one of these? Well, maybe we can still make some improvements in the overall tax system, but we want to do it by——.

Mr. MATSUI. Mr. Baker, I am not suggesting that the President is not sincere. I do question whether he knows what is in the package, but I am not questioning his sincerity, just as I did not question his sincerity in 1981.

I think, frankly, as a result of what we did in 1981, because of his promises on television, we ended up now with deficits of $200 billion for the foreseeable future. My concern is that we do not damage the Tax Code any further by making these laudatory promises to the American people and not being able to carry it out because perhaps the President is not informed about how these goals can be achieved and the inconsistencies in attempting to achieve some of these goals.

Now, let me just go on to the second part. In terms of your statement about the level playing field—and I think, again, it is a laudable goal. But we do know that the trade situation—because Japan has barriers and some of the other countries have barriers, there is no level playing field in that area.

The same applies to the fact that the Government spends 25 percent of total GNP. That creates distortions in the economy as well. And I hope very sincerely that we do not try to achieve a level playing field and elimination of the distortions in the Tax Code without considering the fact that there are other implications as well—trade barriers and, second, the issue of Government spending.

I would also like to ask you in the third and last part of my question, has the differential on capital gains, in your opinion, encouraged new ventures in the United States over the last 7 years?

Secretary BAKER. Yes.

Mr. MATSUI. In terms of ACRS, in 1981 we heard Mr. Regan, your predecessor, say that it would stimulate economic growth and capital formation. Do you feel that that is a desirable goal? Second, has, in fact, that happened?

Secretary BAKER. Well, clearly, economic growth and capital formation are desirable goals. Yes; there has been some capital formation since 1981. Is that your question, or has it been stimulated by ACRS?

Mr. MATSUI. By ACRS.

Secretary BAKER. To some degree, it has been stimulated by ACRS.

Mr. MATSUI. In Mr. Regan's package, of course, he eliminated those provisions. Can you explain the inconsistency, then, in terms of stimulating economic growth in what you have seen as the Secretary of Treasury that, in fact, it has worked, and in his package it eliminated it?

Secretary BAKER. But he substituted some things that I guess we could argue would likewise stimulate economic growth, such as a dividends paid deduction for corporations and lower corporate rates. You know, there are other things that are in the package that we could argue would be stimulative of capital formation.

Mr. **Matsui**. Thank you.

Chairman **Rostenkowski**. Mr. Daub will inquire.

Mr. **Daub**. Thank you, Mr. Chairman.

I am very pleased that our chairman and our ranking member were able to persuade you to join us to start the ball rolling on tax reform. I do not have any questions. I thoroughly enjoyed my colleagues' dialog with you and your candor, and I think I would just make a point and would appreciate your comment on it.

The point would be I see this as a great opportunity for all of us in a bipartisan way to establish the element of fairness, whether it is individual or in some form of business. That is the point I am most attracted to as we proceed down this course. I would appreciate any view you might have with respect to that key point that I am interested in, which, for want of a more appropriate word today, must be called fairness.

Secretary **Baker**. Well, Mr. Daub, I quite agree with you, and we are using fairness now, quite frankly, more than we are simplicity when we try to describe the objectives that we want to achieve.

We think fairness is first; simplicity perhaps is second. As I indicated, I believe, in my opening statement, there is a certain disrespect out there on the part of the American people with respect to our tax laws and with respect to our Tax Code. That translates over, unfortunately, into a certain degree of disrespect or lack of confidence in government generally. I think if we can make the Tax Code more fair and make it more simple so that the average guy feels he is getting a fair shake, we will go a long way toward restoring confidence in Government.

Mr. **Daub**. If one examines the changing demographics from the baby boom/bust cycle of 1978 and, sort of very clearly in an econometric model, looks at the number of taxpayers we are going to have in 1994 and 1995, one can see a shift is going to occur. In my view, that is why we have to be very careful as we proceed to look at that effect of taxpayers as we revise the code, which we are undertaking to do here today.

Secretary **Baker**. Yes, sir.

Chairman **Rostenkowski**. Mr. Anthony will inquire.

Mr. **Anthony**. Thank you, Mr. Chairman.

Mr. Secretary, welcome, and I would like to say that I agree with your statement that my constituents are expressing a great deal of frustration with the Tax Code. They are reading about individuals and corporations earning large amounts of money without having to pay taxes.

Unfortunately, many of them are saying, I can do that without hiring a tax expert or investing in an expensive tax shelter; I will just cheat. This is exactly what your latest survey has indicated.

Additionally, Treasury is getting plaudits from the community for a study well done, and I must tell you a lot of my friends are saying that Treasury did a better job than they thought they would do. So you have a big task ahead of you, and that is to take your proposal and move forward with it expeditiously.

On page 6 of your testimony, regarding simplicity. In the second paragraph you talk about how difficult the Tax Code is and that many people have to go to experts.

You also say it may be May before we look at tax reform. I think you have an opportunity to prove to the American public that you are ready for tax reform before May. March 5, you could come in here and say that you want to support H.R. 531. That is my bill to repeal the contemporaneous recordkeeping for automobiles. It has politically become the son of interest and dividend withholding.

Secretary **BAKER**. We have already indicated an interest in that, Mr. Anthony, as you know. We have already changed our rules; maybe not sufficiently, in your opinion, but we have made a stab at it.

Mr. **ANTHONY**. I applaud you in your efforts to get out of the way of the thundering herd, but they are still running and they are still gathering steam.

Secretary **BAKER**. May I respectfully remind you that it was the Congress that stuck the word "contemporaneous" into that legislation?

Mr. **ANTHONY**. Yes; I would like to remind you that it was the Senate that did it, not the House. [Laughter.]

It is the House now that is trying to correct it, and it is Mr. Anthony that is trying to do it for the House. [Laughter.]

But, anyway, I ask you to take a hard look at it and come forward March 5 with a little bit more reform in your heart than your press release gave last time. I applaud your efforts to try to straighten it out with several modifications.

However, these changes did not go far enough. There has been a public outcry and I think that with the witnesses on record, we will be able to prove to you that we have the opportunity to demonstrate to the American electorate that we are serious about tax simplification.

My second comment is, again, in response to your testimony on page 6, and this one really concerns me. You say that economic neutrality as well as basic fairness requires that all income should be taxed equally, no matter how the income is earned or how it is spent.

That leads me to believe that capital gains is going to be repealed.

Secretary **BAKER**. Well, that is what the Treasury plan calls for.

Mr. **ANTHONY**. Are you supporting that today in your testimony and your statement?

Secretary **BAKER**. Well, as I have indicated, the President's instructions to me, apart from the five items in the State of the Union, are that is a good starting point. I want you to take a close look at everything and come forward with some recommendations.

So I am not prepared to tell you today that that is a sine qua non of any new proposal we might make.

Mr. **ANTHONY**. So then, based on your statement, and based on your answer, everything regarding capital gains is on the table?

Secretary **BAKER**. Everything in the Treasury plan is up for discussion, Mr. Anthony, yes, sir.

Mr. **ANTHONY**. So what you are saying is that those who feel like I do, that is, that there is a need for capital formation, and that a differential for capital gains has been a proven vehicle in generating the economy, will have to prove that to the administration and the Treasury Department.

Secretary **Baker**. Well, we are not prepared to come off the Treasury proposal here this morning, if you understand what I am saying.

Mr. **Anthony**. Yes; I understand.

Secretary **Baker**. What I am saying is that everything—we have got to look at everything together, as you well know, because there are revenue effects when you move in one direction. If we are going to simplify the code, and we are going to get tax rates down for individuals, we have got to take a look at some preferences, deductions, and things like that on the business side. We simply have to do that.

Mr. **Anthony**. Thank you. I think that is a very excellent answer to my question.

Mr. Chairman, I do have a two-page letter that I have prepared for the Secretary, because it does contain many more questions that I knew that my time would be limited. So, with your permission, I would like to introduce it for the record and hand-deliver it to the Secretary.

Chairman **Rostenkowski**. Without objection.

[The following was received for the record:]

BERYL ANTHONY, JR.
4TH DISTRICT, ARKANSAS

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February 27, 1985

The Honorable James A. Baker, III
Secretary of the Treasury
Department of the Treasury
15th Street & Pennsylvania Ave.
Washington, D.C. 20220

Dear Mr. Secretary:

I would appreciate having your comments on the following questions in regard to the Department of Treasury's Report to the President on Tax Reform for Fairness, Simplicity, and Economic Growth. I will be asking Chairman Rostenkowski to include your answers as part of the record on the February 27, hearing before the House Ways and Means Committee relating to fundamental tax reform issues.

1. In Volume 2 of the Treasury Report, it states "since repeal of the i.t.c. would eliminate the bias in favor of property that is eligible for the credit, investment in such property is expected to diminish."

   I assume the Treasury is doing detailed economic analysis of its tax proposals. I would like to see the data on the reduced investment in capital equipment and the resultant reduction of employment, productivity and industrial output. I would also like to see the data on how reduced investment in equipment will affect American companies' ability to compete.

2. In 1981, the Administration proposed capital formation incentives to invest in plant and equipment. Such incentives, coupled with i.t.c., were successful in fueling a growing, prosperous, economic recovery that is continuing today. Won't the new tax proposals greatly reducing capital formation incentives and repealing the i.t.c. destroy the recovery?

3. Economic data recently compiled by Alan Sinai and Otto Eckstein indicates that for every dollar in revenue loss to the Treasury from the i.t.c., 76 cents of additional economic activity occurs. The same data indicates that a dollar lost through corporate rate reduction results in less than 20 cents of economic activity. Why is Treasury abandoning a proven economic incentive that provides tremendous "bang for the buck"?

4. Has the Treasury Department compiled any data on the likelihood of American companies relocating production abroad if the i.t.c. is eliminated? If not, why not? If so, I'd be interested in the results.

5. Do you think it is equitable to have the interest indexing provisions, those provisions that would deny a portion of the interest deduction because of inflation, to apply to existing debt?

6. Normalization of depreciation timing differences has been very important to the capital formation objectives of public utilities. I would appreciate the Treasury Department's thoughts on this issue.

7. I understand that Standard & Poors has said that the repeal of the investment credit would have a significant impact on the bond ratings of capital intensive industries. Do you agree with this analysis, and what overall effect could this have on these industries?

I want to thank you now for your prompt response to these questions.

Sincerely,

Beryl Anthony, Jr.
Member of Congress

BA/rbg

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

04 APR 1985

Dear Mr. Anthony:

I am pleased to respond to your letter to Secretary Baker of February 27, 1985, which contained written questions following his testimony before the Ways and Means Committee that morning.

Please find enclosed Secretary Baker's response to these inquiries.

Sincerely,

Bruce E. Thompson, Jr.
Assistant Secretary
(Legislative Affairs)

The Honorable
Beryl Anthony, Jr.
House of Representatives
Washington, D. C. 20515

Enclosure

Question 1: In Volume 2 of the Treasury Report, it states "since repeal of the i.t.c. would eliminate the bias in favor of property that is eligible for the credit, investment in such property is expected to diminish."

I assume the Treasury is doing detailed economic analysis of its tax proposals. I would like to see the data on the reduced investment in capital equipment and the resultant reduction of employment, productivity and industrial output. I would also like to see the data on how reduced investment in equipment will affect American companies' ability to compete.

Question 2: In 1981, the Administration proposed capital formation incentives to invest in plant and equipment. Such incentives, coupled with i.t.c., were successful in fueling a growing, prosperous, economic recovery that is continuing today. Won't the new tax proposals greatly reducing capital formation incentives and repealing the i.t.c. destroy the recovery.

Answer 1 and 2: The Treasury tax reform proposal would abolish the current depreciation system under which the value of the cost recovery is sensitive to the inflation rate and the after-tax rate of return. This would be replaced with a cost recovery system allowing the full inflation adjusted value of investment expenditures to be recovered. Incentives to invest would increase in areas now heavily taxed and would fall in areas presently lightly taxed. Overall, Treasury and many outside experts expect the incentives for capital investment to increase. In addition, efficiency improvements from letting the market place rather than the government determine the most efficient areas in which to invest will also increase, rather than decrease, productivity and industrial output.

The ability of American companies to compete in international markets has probably been affected by the strong dollar. However, the tax system is not able to--nor should it attempt to--compensate for the current strength of the dollar. Deficit reduction is the appropriate policy to strengthen U.S. exports. Appendix C of Volume 1 of the Treasury Department tax reform proposal compares U.S. taxes with the taxes of our major trading partners on page 258. The U.S. corporate income tax is lower as a percent of GNP than all others except Sweden and Germany. As a percent of GNP, total U.S. taxes are lower than six of the seven countries excluding only Japan. We expect an improvement rather than a deterioration in the ability of American companies to compete, and a general strengthening of the economy from the proposed reform. It should be recalled that the Treasury proposal includes a 50 percent deduction for corporate dividends paid and substantial reductions in personal and corporate tax rates as well as real capital cost recovery.

With respect to job creation, additions to the labor force have been accommodated by expansions of the economy in the past. We expect this to continue in the future regardless of the tax system in place.

Question 3: Economic data recently compiled by Alan Sinai and Otto Eckstein indicates that for every dollar in revenue loss to the Treasury from the i.t.c., 76 cents of additional economic activity occurs. The same data indicates that a dollar lost through corporate rate reduction results in less than 20 cents of economic activity. Why is Treasury abandoning a proven economic incentive that provides tremendous "bang for the buck"?

Answer: An investment credit change does have a smaller immediate revenue impact than a corporate rate change. Changes in corporate tax rates alter tax collections on new and old capital alike, while changes in the investment credit directly affect the incentives to invest in new capital only. However, there are a number of offsetting factors. Change in the investment credit that expands investment in new capital would impose windfall losses on existing capital owners who do not receive the benefit of the change. Also, it should be kept in mind that two proposals that have the same expected value of tax collections on new investment should have the same general economic impact and revenue consequences, once old capital is replaced.

Question 4: Has the Treasury Department compiled any data on the likelihood of American companies relocating production abroad if the i.t.c. is eliminated? If not, why not? If so, I'd be interested in the results.

Answer: The Treasury Department's preliminary review of this issue suggests that the overall effect of eliminating the investment tax credit will be rather small. One reason is that corporate taxes tend to be a rather small component of total costs. For example, the industries that are most seriously affected by the elimination of the i.t.c. would find that their total costs of doing business have risen by no more than 3.0 percent. In addition, in evaluating the overall impact of the change in policy it is necessary to consider the changes in exchange rates that would occur. For example, any shift to imports would cause a drop in the price of the dollar, which would stimulate additional U.S. exports and moderate the initial shift to imports.

Question 5: Do you think it is equitable to have the interest indexing provisions, those provisions that would deny a portion of the interest deduction because of inflation, to apply to existing debt?

Answer: As I stated on February 27th, the Treasury proposal has been altered with regard to this area. We are now proposing that this provision not begin to take effect until 1989, and then be phased in over a ten-year period, at a rate of ten percent a year. Thus, interest deductions on existing debt would be fully deductible until 1989, and would retain partial deductability until 1999.

Question 6: Normalization of depreciation timing differences has been very important to the capital formation objectives of public utilities. I would appreciate the Treasury Department's thoughts on this issue?

Answer: From their initial enactment in 1969 and 1981, the Treasury has supported Internal Revenue Code sections 167(l) and 168(e)(3) that require public utility regulatory authorities to normalize (treat as deferred tax) the effect on current year tax liability of differences in timing as between regulatory allowances for depreciation and tax allowances. Under the December Treasury proposals for replacing ACRS with an indexed system for determining tax depreciation allowances, timing differences, although less than are currently experienced, will continue to occur. In the interest of achieving undistorted temporal pricing of public utility services, the Treasury in all likelihood would support mandatory normalization of these timing differences. However, inflation indexing of tax depreciation allowances will introduce permanent differences between regulatory and tax allowances. The Treasury is presently considering whether specific regulatory accounting for this difference is necessary, and if it is necessary, what form the accounting should take.

Question 7: I understand that Standard and Poors has said that the repeal of the investment credit would have a significant impact on the bond ratings of capital intensive industries.

Do you agree with this analysis, and what overall effect could this have on these industries?

Answer: Bond ratings should depend on the ability of companies to repay debt and avoid bankruptcy. Many capital intensive industries such as utilities and steel that pay large dividends would substantially benefit by the dividend deduction aspect of the Treasury proposal as every dollar paid in dividends pays less than a 20 percent tax. Front loaded deductions and investment credits under the current system often cannnot be fully utilized by capital intensive industries because of inadequate profitability to absorb the deductions and credits. A more neutral cost recovery system would provide a comparative benefit for these companies relative to companies able to use tax benefits currently.

If Standard & Poors has said that repeal of the investment tax credit will have a significant [adverse?] effect on the bond ratings of capital intensive industries, I would disagree with their conclusion. In effect, the investment tax credit is a capital grant, not a "reduction in tax." When $100 is spent on qualified property that gains the purchaser a $10 credit against tax otherwise due, it is clear that the property has cost $90--to be financed by $90 of debt and equity--and that receiving the grant via his tax account has not increased the purchaser's after-tax income ("reduced his tax"). Availability of the credit therefore should have had no effect on debt-equity ratios of corporations nor on their interest coverage ratios. Accordingly, repeal of the credit should have no effect on their credit-worthiness.

Chairman **Rostenkowski**. Mr. Flippo.

Mr. **Flippo**. Thank you, Mr. Chairman.

Mr. Secretary, I do share your concerns about accomplishing tax reform, and the sooner the better. I wanted to explore with you, on page 3 of your testimony, where you are quoting the President's five principles that he talked about in his State of the Union Address, and then later on in your testimony, you appear to comment on four of the five. The President said that tax reform would not be a tax increase. You commented favorably on that in the Treasury report, it is in there; that personal tax rates would be reduced, and seemed to agree with that part of the Treasury proposal. You mentioned that and made a favorable statement in regard to the Treasury proposal that individuals living at or near the poverty line would be exempt.

In mentioning that corporate tax rates would be reduced while maintaining incentives for capital formation, I noted that you commented about reduction of corporate tax rates, but I wanted to understand if your primary concern is in this area of incentives for capital formation. In other words, the favorable comments that you made, in broad terms, seem consistent with most of the concerns that the President had, except perhaps this incentive for capital formation. Is that an area of prime concern to you, since it seems to be the only area you did not make a favorable comment on in regard to the Treasury proposal.

Secretary **Baker**. Mr. Flippo, I said as far back as my confirmation hearings that we want to take a close look at any of the provisions in the Treasury plan which would seriously adversely affect capital formation. That is part of the exercise we are going through.

Mr. **Flippo**. Right. But it appears to me that that seems to be a great area of concern, because all of the other principles enumerated by the President seem to be complied with in the code, according to your testimony later here today.

I am just wondering if—this is, of course, tax incentives for capital formation that we are discussing, isn't it?

Secretary **Baker**. Yes.

Mr. **Flippo**. Among the major items that are tax incentives for capital formation is the investment tax credit and the ACRS, among others.

Is that your basic difference with the Treasury proposal?

Secretary **Baker**. Well, I am not in a position today to say that I have a difference with the Treasury proposal with respect to one item or the other, but let me say this. There are other provisions in there that I think affect capital formation: capital gains could arguably be said to affect it. The Treasury proposal does away with graduated rates for small businesses and that could be arguably said to do something adverse, I suppose. But again, it is a matter of balancing the equities and walking a fine line. What we do not want to do is seriously adversely affect capital formation.

Now, if you are going to reduce the tax rates for individual taxpayers across this country and simplify this Tax Code and make it more fair, as I said a minute ago, you are going to see some increased taxes paid by business. It is as simple as that.

Mr. FLIPPO. Well, I am just trying to understand. It seems that you approve, later in your statement, of all of the other aspects, but you did not seem to comment on that particular one.

Secretary BAKER. Well, I commented at length on that one. I am sorry if I did that, because I did not mean to, because I have commented at length on that one in other hearings.

Mr. FLIPPO. But we are talking about tax incentives for capital formation, for growth, and I note on page 4 an interesting discussion about most economists agreeing that whenever the tax structure is designed to function in a capacity other than to raise revenue to finance Government activities, there will be a misallocation of productive resources. Then later on, it says that, "No matter how well-intended or how carefully planned, that it runs the risk of leading to a lower standard of living for all of us."

I suppose that means that if we are using the Tax Code to encourage home construction, or for any other reason other than to raise the revenue, for capital formation or anything along those lines, that that would be at odds with the statement made there.

Secretary BAKER. It could be at odds with that statement. Yes, sir, in a perfect world, it would be better if we let the marketplace decide and determine. That, as a general principle or goal, is a worthy general principle. At the same time, we do not want to do something that would affect our ability to compete overseas or affect our ability to raise capital in this country.

Mr. FLIPPO. So there are some things that are so important that we should deviate from that market principle that you have laid out?

Secretary BAKER. Yes, sir. In fact, I say in other points in this testimony that, absent compelling reasons to the contrary, we ought to look for economic neutrality. But there can be compelling reasons where you have exceptions.

Mr. FLIPPO. Among those is mortgage interest rates and capital gains.

Secretary BAKER. It could be.

Mr FLIPPO. Thank you.

[Questions presented by Mr. Flippo and Treasury's responses follow:]

QUESTIONS FOR

TREASURY

1. The Treasury Department's tax reform proposal calls for limiting the deductions for business marketing meal expenses. A recent Chase Econometrics study shows that the limits proposed by Treasury would result in a net loss of revenue to the federal government of $570 million in 1986 and $800 million in 1987 due to job losses in the restaurant and hotel industries, lower income and FICA tax payments, and increased transfer payments. In 1987 and later years, the net revenue loss would be even greater. Further, state and local governments would lose $540 million in 1986 and $860 million in 1987.

   Treasury officials have told representatives of the restaurant industry that even if the proposed limits on deductions result in a net revenue loss, it may well remain a part of the overall package. In this time of rising federal deficits, how is this justifiable policy?

2. Restaurant industry people in my district have contacted me to express concern that the Treasury proposal to limit deductions for business marketing meal expenses would severely hurt their businesses and would result in cutbacks in employment. A recent study by Chase Econometrics shows job losses would number 140,000 in 1986 and 190,000 in 1987, nationwide. For 1988 and later years when the phasing-in period is over, the effects would be even more severe.

   With unemployment still a major concern, is it sensible to propose action which will further aggravate the unemployment situation?

3. The stated philosophy of Treasury's reform package is to remove tax considerations from the decision-making processes of business and individual taxpayers. In the case of limiting deductions for business marketing meal expenses, however, it appears that the Treasury proposal would inject tax considerations into the decision-making process. It would appear that business expenditures should be based upon the desired marketing goals of the business --- whether it be advertising costs, office furnishings, travel or business entertainment meals.

   Don't you find limiting business marketing meals inconsistent with Treasury's stated goals of reform, simplification, and removing tax considerations from the decision-making process?

TREASURY RESPONSE TO QUESTIONS CONCERNING BUSINESS MEALS

Questions 1 and 2:

Treasury has examined the Chase Econometrics' study of proposals to limit allowable deductions for business meals. We do not believe their estimates of increased unemployment or of reduced revenues. Their study was designed to estimate the impact of a proposal like that made by the Carter administration in 1978. Using it to estimate the impact of our much different proposal requires heroic assumptions, as they admit on page B-2 of their report.

Moreover, the Chase study assumes that this change is being made in isolation, with no other changes in the tax Code, whereas our proposal must be evaluated as part of a full tax reform package. While the proposal would reduce the demand by businesses and certain executives for expensive meals (See answer to question 3 below), the demand for moderate-priced meals would increase. In addition, for most taxpayers, restaurant meals are not subsidized. The elimination of other preferences from the tax Code will increase the relative demand for such currently unsubsidized consumption.

For these reasons, we have stated that "it is doubtful that aggregate employment in food services will decline at all as a result of the Treasury proposals." (Treasury Department Report, Vol. 1, p. 85). But even if there were a reduction in employment in the restaurant industry, such a shifting of resources need not increase overall unemployment. Given a revenue neutral tax reform, increased taxes on business meals will make possible lower taxes on other income. The money no longer spent on meals does not disappear from the economy, as is assumed in the Chase Econometrics study.

The losses in tax revenue estimated by Chase Econometrics are based entirely on their assumption that there will be large increases in national unemployment rates as a result of this proposal. It is their assumed increases in welfare payments and unemployment compensation that creates the revenue loss. We see no justification for the assumed increases in unemployment, nor for the reduced revenues that they would generate.

Question 3:

The Treasury Department's tax reform proposal is designed to eliminate unnecessary distortions created by the current tax Code. By allowing full deduction for expense-account meals, regardless of cost, the Code distorts business decisions. The business person in the 40% marginal tax bracket considering whether to order a $25 or a $40 "business meal" knows that the more expensive dinner, though its price is $15 higher, will only cost $9 more because of the business deduction. The taxpayer's choice of meals is much more likely to be based on personal rather than business considerations, but the deductibility of the expense makes selection of the expensive meal more likely than in a non-business context.

Chairman **Rostenkowski**. Mr. Gregg will inquire.

Mr. **Gregg**. Mr. Secretary, I do not see that the administration has basically taken a position yet on the underlying question of tax policy traditionally being used to institute social policy and to institute industrial policy in this country—in fact, I guess it is the biggest club we use in the Congress and as a Government.

Hasn't the administration, by putting forward this proposal, essentially said that tax policy shall not be used to institute social policy or industrial policy?

Secretary **Baker**. I think we are saying in a perfect world, it would be better if we did not use the Tax Code for that purpose, Mr. Gregg, but let the market operate.

Mr. **Gregg**. So is that going to be the basic philosophy that drives what you come up with as a final policy?

Secretary **Baker**. That is one of the underlying principles that is in here, yes, sir.

Mr. **Gregg**. Another question. We have heard, basically, that oil and life insurance, and I guess the second home market, industrial and commercial construction, R&D—all of this activity will be impacted negatively—we are hearing that everywhere—if a proposal such as this, which is based on fairness and simplicity passes.

Could you give us a scenario as to why you think that will not happen, how the marketplace forces will allocate dollars so that things will continue to boom in those sectors?

Secretary **Baker**. Well, all I can say, Mr. Gregg, is that we had substantial personal rate reductions in 1981, and we are enjoying, I think, the benefits of that right now. I mean, some would argue that there are other factors that have tended to promote the economic growth or economic expansion we are now experiencing.

It just seems to me that if we can engender respect for the tax system, we will pick up additional revenues by way of the underground economy. We will broaden the tax base, we will generate, quite frankly, sir, I think, by merely reducing personal rates, additional funds for investment and for capital formation and for savings, and promote overall economic growth.

Now, would the beneficiaries of some preferences and deductions today consider themselves less well-off under such a system? Perhaps so. What you do not want to have happen, it seems to me, is to go so far by way of individual rate reductions that you totally stifle our ability to raise capital and create investment and that sort of thing.

Mr. **Gregg**. Is another way to say that, that the dollar is going to flow where it is more efficiently used as opposed to where the tax laws direct it?

Secretary **Baker**. The dollar is going to flow where it is more efficiently used, as opposed to where the tax laws direct it. I think the statement says that as well.

Mr. **Gregg**. Thank you.

Chairman **Rostenkowski**. Mr. Dorgan will inquire.

Mr. **Dorgan**. Thank you, Mr. Chairman.

Mr. Secretary, I would like to ask you about deficit spending. Your administration asks us for about $700 billion in deficit spending in the budget that you have submitted to Congress so far.

It appears to me that we have an imbalance in our fiscal policy as between revenue and spending. The President believes, apparently, that we should have no additional revenues because we will grow out of this deficit problem. Do you believe that?

Secretary **Baker**. No; and I am not sure the President agrees with that, either. I think he says that additional growth will help us cure the deficit, but he does not believe that, or he would not be asking you for a $50 billion outlay reduction in 1986 as a part of his budget.

Mr. **Dorgan**. The President indicates that he would object to different sources of revenue this year. I think it appears that most experts feel that we will not be making major progress on the deficit by dealing only with the spending side. Will you as U.S. Treasury Secretary and will the President provide some leadership on the deficit next year by considering additional revenue raising measures in addition to spending restraints?

Secretary **Baker**. No, sir; the President feels strongly, and so do I, that that would be the absolute wrong way to go. You have got revenues now at about 19 or 19½ percent of GNP, which is a historic level, I think between 1955 and 1980, they were 18.6 percent of GNP. So it is not a case of revenues not being high enough, it is a case of spending being too high. The answer is to handle the problem on the spending side.

So the answer is absolutely no, we will not support revenue increases next year.

Mr. **Dorgan**. So, Mr. Secretary, you are saying to us that you believe that this administration can move us toward a balanced budget simply by engineering the spending side of the budget, is that correct?

Secretary **Baker**. Well, Congress has to act. It is going to take your support. But the President has sent a budget up here that would do that. It would get us to 2 percent of GNP by 1989, if the spending control measures that he asked for were instituted or implemented.

Mr. **Dorgan**. Well, Mr. Secretary, almost everyone in this town understands that those numbers are all cooked up. I mean, they are the same kind of numbers we have been getting for a long time, from Treasury and from this administration. You do not make major progress—and I think most economists in this town understand—you do not make measurable progress in dealing with that deficit by only dealing on the spending side.

Almost everyone, I think, whose opinion is respected in this town believes you have to deal on both sides of the ledger—revenues and spending.

You are saying that you are going to balance the budget by reducing spending. Where are you going to get that kind of spending cut?

Secretary **Baker**. That is not what I said. I said we are going to get the deficit down to about 2 percent of GNP by 1989, if you will simply make the spending cuts the President has asked for in the 1986 budget.

Mr. **Dorgan**. Well, I guess I just feel that is a sense of economic faith-healing——

Secretary **Baker**. Mr. Dorgan, I do not think we will ever get there if we just keep raising taxes, because we will just keep spending it.

Mr. **Dorgan**. Well, let me just say this; 4 years ago, the administration came in and said to the American people, Now, I want you all to screw up your guts, because it is going to take some courage to go where we are going. I want you to follow me toward 3 years of tax cuts.

And the American people thought hard about it and said, "Well, we will do that. It is a tough choice, but we will accept that," and went right along with the administration.

Now it comes time for some very tough decisions, on spending and on taxing, and there is not leadership. There is not leadership that says it is time for us to screw up our guts again and to follow in the direction that leads towards balanced budgets.

I am saying we are not going to get there with the kind of proposals that you have put before Congress.

Secretary **Baker**. Well, you are just ruling them out in advance, and I would argue with you that there is leadership. The President has sent a budget up here, and you know, he cannot make you act on it, but he is going to be, has been, and will continue to be very public with respect to his support of those cuts. I will admit to you that they are not politically easy. They are not politically easy cuts for him.

As far as tax increases are concerned, we have raised taxes, let's see, four times since the 1981 tax cut. We have had TEFRA, gas tax, Social Security compromise, and the Deficit Reduction Act of 1984 which, by 1988, I think, raises $408 billion in taxes.

So, we are not undertaxed.

Chairman **Rostenkowski**. Mr. Secretary, I am very happy to hear you say that you have raised taxes.

Mr. **Dorgan**. Thank you, Mr. Chairman.

Mr. Secretary, the proof is in the numbers. We had a $900 billion Federal deficit when I came here, and now it is nearly $1.7 trillion.

We have got a serious problem, and that deficit is not diminishing; it is increasing. We talk about this glide path all the time, but the fact is, we are not on a glide path towards progress here, and you have got to deal with both sides.

But my time is about out, and I would like to ask one other question, if I might. I would like to kind of get a sense from you about how you feel about tax reform. And I appreciate your statement today; I think it was a good statement. Every politician promises to reform taxes, and no politician keeps that promise, because it is the hardest thing in the world to do.

Are you an anxious tax reformer? Are you coming here as a crusader, or are you simply willing?

Secretary **Baker**. No; I would prefer to characterize myself as a crusader, because I think that is the view the President has on tax reform. And I think I would submit to you respectfully that the President has made some promises that people did not think he was going to be able to keep, and he has kept. And I, quite frankly, liked what the chairman said in his speech to the Economic Club of New York a couple of nights ago, because I think the American people want a system that is fair and that is simple. I think people who underestimate the President, as the chairman said a few nights ago in this regard, are making a serious mistake.

Mr. DORGAN. Well, I appreciate your answer, and I despair of the lack of leadership on the deficit, but I do commend you and the President for what I hope will be good, strong leadership on tax reform, and you will find that I am someone who is very willing to go along with you on it.

Chairman ROSTENKOWSKI. Mrs. Kennelly will inquire.

Mrs. KENNELLY. Thank you.

Mr. Baker, the last time you and I had business, I was running a primary in Connecticut, and you were running a candidate. You have got a President, and I have got a new job. I just hope you are as pleased as I am.

Secretary BAKER. I was running a different candidate, I have to admit—but I am very pleased.

Mrs. KENNELLY. Mr. Secretary, I would like first of all to join with Mr. Stark and Mr. Moore in their remarks. They did yeoman's service last year in rewriting the insurance tax law, and the whole industry had to wait for a year and a half while we worked on a product. And it is rather embarrassing now to say, "Well, gee, guys, gee, women, this does not mean anything now, because we are off doing something else." So I just want to join my voice with theirs.

Mr. Baker, on page 4, you say that "The tax system has long been misused to try to serve one special interest or another."

Now, Mr. Secretary, having said that, my question is, do you feel the system has been at times also well-used to provide help or protection for individuals in these United States?

Secretary BAKER. Yes.

Mrs. KENNELLY. Thank you. I say that, sir, because what I am a little afraid of is that we are moving along here—and I am an enthusiast for tax reform—that we are moving along, and I just hope that as we go forward, we do not let the American people think just a few tax forms are going to be changed, and that other person is going to pay their fair share. The American people are going to lose certain things in the tradeoffs, and I think we have got to get that out and educate the people before we make any final decisions.

Secretary BAKER. Well, I quite agree with your statement that, while it has been poorly used and ill-used in the past, I cannot deny that it has been well-used. I suppose we would take the position that it is being well-used with respect to the home mortgage interest deduction, since we are in favor of protecting that.

I do not think it is totally one way or the other, and that is the point I was trying to make in answer to a question over here. For us to reform the Tax Code is going to involve balancing the equities and walking a fine line between individual rate reductions on the one hand and doing some action that might be detrimental over on the capital formation side, on the other. We do not want to do that latter, but we do want to do the former, and we are committed to doing that.

Mrs. KENNELLY. You see, that is a perfect example, the home mortgage deduction. People for years now have known that if there was tax reform, that could be eliminated, and they for years have said, "No, you cannot eliminate that." So that is already off the table.

And there are other things, though, that I think they do not know would be eliminated, and I just hope all of us—the committee, you, the President—let the people know that these benefits could possibly be eliminated.

One other question, Mr. Secretary. The underlying philosophy of this administration is that it would be good to let the private sector do what they can before you let Government get involved. And yet, some of the Treasury proposals seem to run the danger of discouraging some private sector ventures.

I just want to know, is this inconsistent with the administration's belief that we should let private industry do something before we let the Government get involved?

Secretary **BAKER**. Well, no, I do not think you could—I mean, there may be instances where it would be inconsistent, but I suppose you could say it would be inconsistent if we did not do more in the Tax Code to encourage private sector involvement.

So again, like everything else here, it is going to be a question of degree. There may be some inconsistencies there. I do not think they would be major.

Mrs. **KENNELLY**. Well, I know we have never had a universal health system. We can hardly seem to handle Medicare at this point. And I just wonder if health care provided by the private sector is reduced, if eventually the people will say, well, we have got to do better, and the Government will have to provide health care. I would not want to see that.

Secretary **BAKER**. No, and we are not seeking to eliminate private sector initiatives. I cannot say to you, though, that an overall reform of the Tax Code might not in some instances discourage a private sector initiative here or there. I just cannot.

Mrs. **KENNELLY**. Thank you, sir. Just one last question. The Washington Post today carries a story which says that Commerce Secretary Mac Baldridge believes that we should retain incentive for business investment in the new tax simplification plan.

Would you agree with that statement?

Secretary **BAKER**. Pertaining to what?

Mrs. **KENNELLY**. That we should retain incentives for a business investment.

Secretary **BAKER**. I have said, again, going as far back as my confirmation hearing, that we have got to take a look at provisions of this plan that might adversely affect capital formation and investment, and I think we do need to do that.

Now, when Secretary Baldridge says we have got to retain everything that encourages it, you know, if we take that too far and accept that as a general principle, we will never have tax reform.

Mrs. **KENNELLY**. Thank you, Mr. Secretary, and thank you for telling us that we are going to have something specific on May 1. I will be delighted at that.

Chairman **ROSTENKOWSKI**. Mr. Schulze will inquire.

Mr. **SCHULZE**. Thank you, Mr. Chairman.

Mr. Secretary, I would like to join my colleagues in welcoming you in your first appearance before the committee as Secretary of Treasury. Although we did not agree on everything while you were in the White House, I was sometimes amazed at the way you were able to come through with dramatic accomplishments, and I congratulate you on that, and I think that you have a very difficult job.

For as long as I can remember, people have been talking about tax reform. Administrations come and administrations go, and they all run on tax reform, and very little is really accomplished, because it is a very, very difficult goal.

So your goals are lofty ones, and they are difficult ones. I wish you well. I guess we have had an example here this morning regarding the influence of special interests in some of the questions and the discussions which have gone on, and I may raise another one.

That is going to be one of the problems in this whole process, really: To try to determine what is a special interest. And because I represent a Northeastern industrialized State, am I then categorized as worried about special interests? I guess we all have a variety of interests.

My topic has been discussed before. For a variety of reasons, we are, in my opinion, losing the international trade war. We are losing the battle for a market position, both here and abroad. I think we have to make sure that the end-product that we deliver to the people will not be unilateral economic disarmament in this international trade war. I think that you have to very carefully keep an eye on that which we do, and we all want, like that phrase, "a level playing field", but we have got to realize the effects of what we do on the business community as it tries to be competitive in the international situation as it exists. And I guess what I am looking for from you is just some guidance that you, as you instruct your staff to refine this proposal, will keep an eye on that, and that you share that concern. I think with the tremendous trade deficit we have, it is imperative that we do not further exacerbate that situation.

I would like to have your thoughts on that.

Secretary BAKER. Well, you have my assurance, Mr. Schulze—I think I have given it before here this morning—that the trade deficit is a matter that we view very seriously, and we would not want to do anything that would be disruptive or shortsighted or——

Mr. SCHULZE. Jim, I might even hope you would go a little further than that and say that what we have got to do is try to reverse this enormous imbalance. And I am not trying to pin you down——

Secretary BAKER. Well, we would like to reverse this imbalance. I do not think that a reform of the Tax Code, quite frankly, is the place in which to do that. We are working on a number of other fronts, as you know, including trade initiatives. Quite frankly, if we could do something and we could get some action on the President's spending control requests with respect to the deficit, I think it would help.

Mr. SCHULZE. Well, I am not sure that it would. In fact, that might make the dollar even stronger, and——

Secretary BAKER. Short-term only.

Mr. SCHULZE [continuing]. Yes; and might make it more difficult. I think that part of our problems—we had some criticisms here earlier about lack of leadership but quite frankly, part of our problem overseas with the strong dollar is because of strong leadership and that we are looked to as this economic engine that is really pulling the economy in the whole world.

My time is drawing short, but I just want to urge you and your people as they work on this—and I know that you will find the committee most cooperative—to see that we do everything we can to try to pull us out of this trade deficit and not let that become built in and become systemic as we go down the road.

I thank you.

Chairman ROSTENKOWSKI. Mr. Coyne will inquire.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Secretary, I was wondering if you could give us your assessment of what the relationship between corporate tax incentives and capital investment for those corporations is? One study that I have read indicates that the 50 lowest taxed nonfinancial corporations had an average tax rate over 3 years of minus 8.4 percent, and that they had reduced their investments, in fact, by 21.6 percent. At the same time, 50 corporations with the highest rates increased their investment by 4.3 percent while paying 33 percent of their profits in Federal income taxes.

I would just like to hear more of your assessment of the relationship——

Secretary BAKER. I do not have any study, nor am I aware of one—we probably have one in the Department, Mr. Coyne—that would either rebut or confirm what you have just mentioned. And I would hesitate, really, to express an opinion on it off the top of my head. I would prefer, if it is all right with you, to take the question and get an answer back to you.

We may have a study in the Department that I am not aware of.

Mr. COYNE. But overall, I assume, because you seem to think that maybe tax incentives would be a primer of the economy, given the 1981 tax bill, my view would be that incentive would encourage investment.

Secretary BAKER. Yes, sir, that would be my off the top of my head view.

Mr. COYNE. OK. Well, I will submit this question for the record and have you respond to it in writing.

Secretary BAKER. All right, thank you.

Mr. COYNE. Thank you.

[The following was received for the record:]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

12 APR 1985

Dear Mr. Coyne:

Thank you for your February 28 letter to Secretary Baker concerning the relationship between corporate tax incentives and corporate investment.

The Reagan Administration believes that low tax rates are essential to keep the American economy healthy, competitive internationally, and growing rapidly. Although there may be some disagreement about the ways to achieve this objective (for instance, how much incentive for plant and equipment should be used in preference to lower tax rates), there is widespread, nonpartisan recognition that savings and investment should be encouraged. Present investment incentives stem from changes made in 1962 when the investment credit was introduced and depreciation schedules were liberalized to stimulate lagging levels of investment. ACRS accelerated depreciation deductions when rapid inflation during the 1970's eroded the value of existing depreciation allowances.

The findings in the McIntyre and Tipps study that between 1981 and 1983 corporations with lower than average tax rates had smaller than average increases in investment and larger than average increases in dividend payments are disturbing, but without significant further analysis, it is not clear that the results are meaningful. Certainly, their findings do not support their conclusion that corporate tax incentives, mainly the investment tax credit and ACRS, have not been been effective in stimulating corporate investment. How corporations used their increased cash flow from incentives in any one year is not nearly as important as how the level of investment with existing incentives compares with the investment level which would have occurred in the absence of incentives. Though the level of economic activity will influence the need to invest at any given time, that does not imply that the price of capital, as partially determined by tax incentives, does not also have an impact. Moreover, the availability of leasing provisions had enabled some corporations to indirectly provide investment incentives to others which could not use them directly.

The data cited by McIntyre and Tipps must be interpreted with care. We must first ask why certain corporations had low tax rates. If low taxes are associated with low demand and low profitability, the firm's investment could be on a cyclical decline, but levels of investment could still be substantial--and higher than in the absence of incentives. Since differences across firms are affected by economic cycles, comparisons at a point in time may be misleading.

There are other potential questions about the McIntyre and Tipps findings. They examined changes in investment between 1981 and 1983 without examining levels of investment spending. They did not look at the differing effects of downturns on various industries, nor did they examine how much of the results may be due to inter-industry differences which should have been held constant. Finally, McIntyre and Tipps examined the firm's overall effective tax rate for a single year rather than the more relevant effective tax rate on the new investment.

We strongly believe that a tax system which does not unduly burden capital investment is necessary to keep us competitive internationally. Unless we maintain sustained high levels of investment, our industry will not remain competitive, the U.S. economy will not provide the steady stream of new job opportunities which are necessary for a vibrant economy, and our citizens will not have the benefits of sustained increases in per capita income.

Although past investment incentives have been very important in counteracting high tax rates and the effects of inflation, we recognize that lower and more uniform tax rates reduce the after-tax economic cost of capital for all types of investment, including depreciable property, inventories, intangibles, and human capital. The Treasury Department tax reform study has proposed that as part of fundamental tax reform depreciation allowances should be indexed for inflation and be based on economic depreciation, the investment tax credit should be eliminated, and individual and corporate marginal tax rates lowered significantly so that all types of investment would be encouraged.

In closing, let me emphasize that our goal is an equitable and efficient tax system which helps to stimulate a healthy economy, sustain growth, and promote ever-higher levels of income. We believe that high levels of investment and low tax rates are essential to help attain that goal.

Sincerely,

Bruce E. Thompson, Jr.
Assistant Secretary
(Legislative Affairs)

The Honorable
William J. Coyne
U.S. House of Representatives
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February 28, 1985

The Honorable James A. Baker, III
Secretary
Department of the Treasury
Washington, D.C. 20220

Dear Mr. Secretary:

As you know, at yesterday's hearings before the Ways and Means Committee I raised the question about the relationship between corporate tax incentives and corporate investment and I indicated that I would enlarge on the question in a letter to you.

A study by the Citizens for Tax Justice conducted by Robert McIntyre and Dean Tipps examined corporate tax payments for 238 major corporations from the perspective of corporate investment. The study found that the 50 lowest taxed non-financial corporations in the study had an average tax rate in the 1981-1983 period of minus 8.4% while these same corporations reduced their investment by 21.6%. For that same period the fifty corporations with the highest tax rates increased their investment over the same period by 4.3% while paying 33.1% of their profits in federal income taxes.

The study concludes that the 238 companies surveyed increased dividends by 17% over the three year period, 1981-1983, reduced investments by 15.5% and paid 14.3% of their profits in taxes. 52.9% of these firms reduced investments and 109 increased dividends. The study also states that while business investment declined by 9% during this same period these companies used incentives to avoid almost $90 billion in federal taxes.

Would you please provide me with an assessment by the Department of Treasury of the effect of corporate tax incentives on corporate investment?

Thank you for your assistance.

Sincerely,

William J. Coyne

William J. Coyne
Member of Congress

WJC:gg

Allen H. Lerman
February 20, 1985

"The Failure of Corporate Tax Incentives: A Study
of Three Years of Growing Loopholes and Lagging Investment"

by Robert S. McIntyre and Dean C. Tipps
Citizens for Tax Justice, January, 1985

The conclusion of this paper is that corporate tax incentives, mainly ACRS and the investment tax credit, have NOT been effective in stimulating corporate investment.

The conclusion is based on a comparison of data for 238 large corporations for 1983 with similar data for 1981.[1] Data were limited to domestic profits, actual tax payments (and tax rate), investment, and dividend payments. The data are alleged to show that companies "with the lowest tax rates reduced investment at above-average rates, while the highest-taxed companies actually increased their investments." On average, the 238 companies reduced investment between 1981 and 1983 and did so at a faster rate than the overall investment decrease throughout the economy.

The report also points out that while companies with the lowest tax rates had the greatest decrease in investment they had larger than average increases in dividend payments (not dividend rates).

The report claims that investment decisions are demand-driven; thus, tax incentives are not effective stimulators of investment. Therefore, these incentives represent an unwarranted revenue loss exceeding $100 billion per year. The funds from the tax incentives are used to increase dividends and to increase corporate cash reserves, one use of which may be to finance corporate takeovers.

Note: The methodology in the report is deficient in that it compares U.S. tax on world-wide income with a calculated domestic profit (domestic profits less state and local taxes). If those corporations paying high U.S. taxes were doing so because of foreign profits, the correlations between tax rate, investment change, and dividend change would not be valid.

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[1] The sample was based on the Fortune listing of large companies. All such companies which supplied the requested data and had domestic profit in both years were included. Although not a scientifically accurate sample, it appears to be unbiased.

The table below reproduces the average tax rate and the percentage changes in investment and dividends for some of the groups of companies cited in the report.

CORPORATE TAX RATES AND INVESTMENT AND DIVIDEND CHANGES, 1981-83

	Average Tax Rate	Percentage Change	
		Investment	Dividends
238 non-financial corps	14.3%	-15.5%	+17.0%
50 corps with lowest tax rates	- 8.4	-21.6	+14.1
50 corps with highest tax rates	+33.5	+ 4.3	+10.7
15 non-financial corps with zero or less tax in each of three years	- 8.5	-29.6	+ 9.5
58 non-financial corps with zero or less tax over three year period	- 6.7	-19.3	+17.6
118 corps with zero or less tax in at least one of three years	- 0.3	-15.7	+21.2

Chairman **Rostenkowski**. Mr. Gephardt will inquire.

Mr. **Gephardt**. Thank you, Mr. Chairman.

Mr. Secretary, it is heartening to read and hear your testimony. I think it is very consistent with the President's statements and with the desire to achieve real tax reform. I also want to commend the chairman of the committee for the speech that he gave, which I think really sets out a way in which tax reform could be realized in 1985.

I think that for those who have been working on this subject for some time, there is a belief that there are two conditions that are necessary to actually achieving tax reform in 1985, which I think is the year to do it.

The first is that it be a bipartisan effort. I for a long time believed there would be Democrats and Republicans who are for tax reform, and there would be Democrats and Republicans who, for equally sincere reasons, would be against tax reform. And I think that it has been proceeding on a bipartisan track.

But secondly, I for a long time believed that a necessary condition was the President being for a specific proposal, and fighting intensely for a specific proposal.

With respect, I believe the President has not shown on the budget the kind of leadership that we will need on the tax issue if we are to achieve a successful result. I have said before publicly that I feel on the budget, the President has been a bystander President and has not put forth the kind of leadership to arrive at a consensus to really solve that problem. I think symptomatic of that is sending down budgets that have deficits, consistently large deficits, and then asking for a balanced budget amendment to the Constitution.

My concern here is that we not follow that pattern, and it is why I believe that both the timing and the specificity of the proposal you make is very important to the outcome on this issue.

On timing, if you are saying that in 4 to 6 weeks, you will decide how to present the President's intentions, and then that will be presented at a later point after that, I get worried that the year will slip by.

Secretary **Baker**. Let me answer that right now, so that I can clear it up for you.

Mr. **Gephardt**. Yes.

Secretary **Baker**. I said "shortly thereafter," and I mean shortly. I think Mr. Pickle mentioned the date of May 1, and in effect basically said, "then you think you would be ready to go". We would be perhaps in full-fledged markup on the first of May. I nodded affirmatively. The first of May is a date that sounds reasonable to me. That would give us the 4 to 6 weeks we need to pull a package together. You say a package has to be bipartisan. I quite agree with you. But it occurs to me that the worst thing in the world we could do is to come up here with a very, very specific piece of legislation that did not have bipartisan support.

We need some time to pull together a package that enjoys bipartisan support. No question on the issue of specificity. I quite agree with you. We have to present a specific proposal. Now, whether it is in the form of legislation or the form that the Treasury proposal is in, changed as we think it is necessary to change it, which is quite specific, I really cannot answer.

So, I do not think there is any difference between us, hopefully, on that score.

Mr. GEPHARDT. And you feel that in that time frame of May 1, we will have either fairly specific specifications, or more specific specifications, but a concrete plan that the President feels is a good plan, and hopefully, it will be bipartisan.

Secretary BAKER. Mr. Gephardt, for 2 or 3 weeks now, I have consistently refrained from putting a date on it, because I do not want to miss that date by a few days or a week and have everybody out there says, "Right, aha, failure. That is the end of tax reform." So I have consistently refused to specify a particular date. I would rather say 4 to 6 weeks from now, we will tell you the form in which it is coming, and shortly thereafter, you will have it.

Mr. GEPHARDT. The second quick question has to do with intensity. I have been on the committee for 8 years and have watched a number of tax bills and have some little sense of the intensity of the politics of taxation. And in my view, it exceeds the politics of almost any other issue that we deal with in the Congress, for obvious reasons. And I think a necessary prerequisite for our success is creating an understanding in the country among the public, the general public, that there is a simple trade-off here between getting rid of loopholes and lowering rates. And, as much as that has been said by the President and others, my belief is that if we are to succeed, that point has got to be driven home, repeatedly, to the American people. And my hope is that the President, who has unusual skills at communication, will use those skills to try to get the American people to understand what is going on there.

Secretary BAKER. I can assure you he will, Mr. Gephardt. I cannot disagree with you that the focus to date has been on the—if you want to characterize it this way—negative aspects of tax reform rather than on the positive. And we quite agree that the emphasis has to be moved around, and I am biased, but I happen to believe that the President is the person who can do that.

Chairman ROSTENKOWSKI. Mr. McGrath will inquire.

Mr. MCGRATH. First of all, let me welcome the Secretary to the committee, and let me say at the outset that if your job in the White House as Chief of Staff is any precursor to the kind of job that you are going to do as Secretary of Treasury, the country will be well served. I am delighted to have you here.

Secretary BAKER. Thank you, sir.

Mr. MCGRATH. Mr. Secretary, as you probably know—and this is the third time I have spoken to you about it—I represent a portion of the country that has some of the highest real property taxes in the Nation. Naturally, I am quite concerned over the provision in the Treasury proposal that would eliminate this itemized deduction.

An area of particular concern in this regard is education. Some sources have estimated that the loss of this deduction in New York State would increase the actual burden of school taxes to about $2.1 billion. Since more than half of all property taxes collected in New York, and two-thirds in my own district, go directly to our schools, elimination of this deduction would produce an unacceptable choice of higher taxes or less education.

Now, can you tell me whether the Treasury Department has done any kind of detailed analysis of the impact of the elimination of this deduction on the ability of the State and local governments to provide these services, which are mandated in their constitutions and by local tradition?

Secretary **BAKER**. Well, I do not know what you mean when you say a "detailed" study. We do have some studies that we have pulled together. I think we supplied you with one of them, that would indicate that a median family of four in your State is better off under the Treasury plan than they would be otherwise, in terms of total taxes paid. Now, that does not address the point that you made, and I acknowledge that.

I do have to say that it is my understanding that New York State, like 32 other States that have a tax, apply that tax rate to the adjusted gross income—Federal adjusted gross income—of the taxpayer to arrive at the State tax owed. If the Treasury proposal were law, adjusted gross incomes would increase, and the State would have a larger take——

Mr. **McGRATH**. Well, that is the State income tax you are referring to.

Secretary **BAKER**. You are talking about the valuation on the home——

Mr. **McGRATH**. That is correct.

Secretary **BAKER** [continuing]. As a result of the denial of the ad valorem tax deduction.

Mr. **McGRATH**. That is correct.

Secretary **BAKER**. I cannot answer whether we have a study or not. Hang on a minute. [Conferring with staff.]

I am told, Congressman, that our Office of Domestic Finance is looking into that and has been for about the past 2 to 3 weeks, pursuant to a question I received some time ago.

Mr. **McGRATH**. May I just add that another outside study indicates that the average value of a home, an $85,000 average price home under the Treasury proposal, would be reduced by $9,500, or 11 percent. And when you add a property tax to a lower valued home, then necessarily to get the same amount of revenue, you have to increase the taxes. And I am not sure that is exactly what we would want to do to shift the burden to the local property taxpayer by the imposition of this kind of proposal.

Secretary **BAKER**. Well, I certainly would not argue that that would be a desirable result; I will not argue that. I will not acknowledge or concede yet that that is the result. We have this study ongoing, which we will be glad to share with you over the course of the coming days and weeks.

I will say that while we have received some comments on the proposal to delete the State and local income tax deduction, they have not been of the volume, and to the extent, that we have received comments with respect to the other elements of the Treasury plan.

Mr. **McGRATH**. Well, if you are looking for some comments on it, I will be happy to supply them to you.

Secretary **Baker**. I am not suggesting that you go out and generate any, because we have got plenty of comments coming in on this plan overall.

Mr. **McGrath**. Very good, Mr. Secretary. Thanks very much.

Chairman **Rostenkowski**. Mr. Rangel will inquire.

Mr. **Rangel**. Thank you, Mr. Chairman.

Mr. Secretary, I appreciate your testimony and, since we are only dealing with a flexible proposal, I took the liberty of introducing H.R. 1040, which basically would be the proposal that your predecessor brought forth. I hope that we might be able to use that as a working document before we come in with more flexibility on some of the questions that concern me.

You said earlier, and I agree with you, that we cannot forget that many of the working poor, and especially those people that have been designated by Federal standards to be below the poverty line, do not have lobbyists. I hope that you are prepared to state that one of the main objectives of the reform proposal is to drop these people from the tax system completely, I think by stating that unequivocally, you will in fact be creating a lobby for these people. Maybe they will not be able to come down here with the three-button suits, but I am certain that the churches and other organizations that are concerned about the poor—especially the working poor—would be able to rally around this moral issue.

Is it safe to say that this is one of the proposals that the administration is not prepared to be flexible on, but is certainly committed to dropping the poor and the near-poor from the tax system?

Secretary **Baker**. Yes, sir. Let me give you the President's own words. "Individuals living at or near the poverty line will be exempt from income tax."

Mr. **Rangel**. I hope you might consider, too, because as you pointed out, the administration has supported some sharp increases in taxes, and you included in that payroll, more specifically, the Social Security tax. These people at the lower end of the economic ladder have had sharp increases in taxes as a result of—and I do hope that the administration might even consider increasing the earned income tax to compensate for that sharp increase they have had in payroll taxes.

I assume this is within the realm of flexibility.

Secretary **Baker**. I am sorry, Congressman. I did not understand the nature of your question. Increasing what with respect to the income tax?

Mr. **Rangel**. The earned income tax credit, the credit that we have.

Secretary **Baker**. I could only tell you that would be something that we would look at as a part of the formulation of the overall plan, Congressman.

Mr. **Rangel**. In my proposal, which tracks the administration's proposals, are certain provisions that I deleted. One of them is the local and State taxes. It was my thinking that since this administration really believes that more services should be provided on the local and State levels, and since there have been such sharp decreases in Federal assistance, health and education and general domestic programs, I would think that you would want to provide incentives for the States and local governments to become more involved in establishing the priority of their constituents.

For these reasons, I would think that to tax those States which are raising their taxes to do this might be in conflict with the national interest, as seen by the President.

Secretary **Baker**. Are you talking about the State and local income tax deduction?

Mr. **Rangel**. Yes, I am.

Secretary **Baker**. That has significant revenue impact, Congressman, No. 1. No. 2, the States in the aggregate, States and localities in the aggregate, are—and I realize that there are differences of opinion with respect to the accuracy and validity and viability of the study—but the State and local governments are in surplus. The Federal Government is a long way from being in surplus. We are talking about revenue neutrality in this bill. But if we are going to be able to lower income tax rates on individuals to the extent that we are talking about, we cannot get there if we are going to start writing out those deductions and preferences that generate revenue.

Again, we have not come to any final conclusion with respect to that one, just like we have not with respect to any other.

Mr. **Rangel**. My last question, Mr. Secretary. Could you tell me why the R&D credit, which is out of my bill, was in the administration's proposal?

Secretary **Baker**. I can only tell you that that was the only credit, as far as I know, that the Treasury proposal contemplates retaining.

Mr. **Rangel**. Why is that?

Secretary **Baker**. Well, I suppose that the drafters of that proposal thought it was important to encourage research and development—that this country was founded on and thrived on its entrepreneurial spirit and its ability to excel technologically, and we do not want to do anything that would destroy or damage that.

Mr. **Rangel**. Thank you, Mr. Secretary.

Mr. **Pickle**. Would the gentleman yield?

Mr. **Rangel**. I yield.

Mr. **Pickle**. I think the Secretary made a good recommendation, and I agree with that.

Secretary **Baker**. I hope you did not misunderstand me, Mr. Pickle. Everything is on the table.

Mr. **Pickle**. Well, I understood you to say that you included R&D in your proposal.

Secretary **Baker**. What I said was that—he asked me why the Treasury Department included it in the original proposal, and I tried to answer why without saying that as far as we were concerned—I mean, we are going to be looking at everything, including the R&D credit. I do not mean to be taking a position here today of saying that it is going to be in the proposal we send you in 4 to 6 weeks.

Mr. **Pickle**. Well, I have interpreted your position.

Chairman **Rostenkowski**. Mr. Donnelly will inquire.

Mr. **Donnelly**. Thank you, Mr. Chairman.

Mr. Secretary, let me congratulate you on your statement this morning. I am happy to see you put this concept into a specific timeframe. I think it is critically important, if we are going to achieve our mutual goal of simplifying the tax system and making it fair, that we set ourselves a time limit.

Let me urge, along with Mr. Gephardt, that the President send specific legislative language here to the Congress, because in the real world, Mr. Secretary, without the strength and the powerful leadership of the great communicator, this piece of legislation will be dead-on-arrival here in the Congress.

Secretary BAKER. Even if we sent you detailed specifications, as opposed to specific legislative language, they would be sent by and on behalf of the President and carry his endorsement. I suppose that would be sufficient, would it not?

Mr. DONNELLY. With his strong endorsement and strong public support.

Secretary BAKER. Absolutely, absolutely.

Mr. DONNELLY. We have a more specific problem on this committee at the present time, Mr. Secretary. That is, there are various recommendations in the President's budget to change the Tax Code, in fact, to make the Tax Code a little more convoluted, for example, tuition tax credits and enterprise zones. We also have a series of sections of the code that are going to expire at the end of this calendar year—the R&D tax credit, for example, that was just mentioned and liquor and cigarette taxes.

What would Treasury recommend that we do on these proposals, both the President's proposal those that will expire at the end of the calendar year, as Treasury now is ready to send up to us a broad-based tax simplification plan?

Secretary BAKER. Well, I would hope we would be able to consider those in overall overhaul of the tax system. If it looks like we are not getting there—if it does not look like we have got the support on a bipartisan basis that is going to be required to move this this year, then I would suggest, our recommendation would be to take those matters up in the normal course of business and deal with them.

Our tuition tax credits and enterprise zone proposals are on the table, and they stay there, and that is legislation we would like to see enacted. But I have said earlier that if we are going to get to overall reform, then we ought to incorporate those in that process, just like we ought to incorporate the expiration of the R&D tax credit in that process.

Mr. DONNELLY. Well, it seems to me we have two diametrically opposed processes going on here, Mr. Secretary. We have the process that will be taking place over at Treasury which involves looking at each and every section of the Tax Code and coming up with some recommendations to simplify the tax system.

Secretary BAKER. Right.

Mr. DONNELLY. On the other hand, we have before us at the present time some recommendations by the administration for tax legislation, and some Tax Code provisions that will expire at the end of the calendar year. Ought not we put all of those things on hold until we hear from you and the President?

Secretary BAKER. If I may be so bold as to suggest, I think you have had the administration's proposals on hold for quite some time, and——

Mr. DONNELLY. Well, we have never had until the present time such great leadership, Mr. Secretary, in terms of dealing with the issue of tax fairness, equity, and simplicity.

Secretary BAKER. You are not faced with a difficult position with respect to those. You are faced with a decision, I suppose, about moving with respect to those things which are going to terminate that you have to deal with. And again, I cannot be any more definitive than I have been. If we get there, our proposal that we submit to you will deal with the R&D tax credit. I do not know which way it will deal with it, but it will deal with it, and you will have it before you. It should also deal with tuition tax credits and enterprise zones and the other matters that are pending from a revenue standpoint.

Mr. DONNELLY. So in reality, it would not make much sense for this committee to proceed on those issues while you are coming forward with a piece of legislation and recommendations that will deal with those same issues?

Secretary BAKER. Well, we would like to see you begin to move on enterprise zones and tuition tax credits, just on the off-chance that we might not be able to come up with an overall package.

Mr. DONNELLY. If I could have an additional 30 seconds, I just do not understand how we can make the Tax Code more complex during the course of the next 6 months, and then by May 1 or whatever that date is, Mr. Secretary, make the code simpler. It seems to me a lot of time wasted and a lot of additional paperwork.

Secretary BAKER. Well, I have already said if you are going to make it simple, then we should deal with those matters. But if you are not going to make it simple, and you are going to keep it complex, then we have got a couple of complexities we would like to add. [Laughter.]

Mr. DONNELLY. Well, we also have a few that we would like to add, I suppose.

My time has expired, and we will continue this debate later.

Chairman ROSTENKOWSKI. Mr. Secretary, I remember some years ago when "New Federalism" was the code word down at the White House. We are not against "New Federalism" or the States doing it for themselves, are we?

Secretary BAKER. Oh, no.

Chairman ROSTENKOWSKI. Are not enterprise zones being created by several States? As a matter of fact, it appears as though they are accomplishing the policy objectives of a Federal enterprise zone proposal, but with a great deal less regulations.

Secretary BAKER. They are doing some good things, but we could set a good example if we were to do a little bit of it.

Chairman ROSTENKOWSKI. Mr. Secretary, that sounds like deficit spending again. We are very conscious of not spending money that we don't have.

Mr. Crane may inquire.

Mr. CRANE. Thank you, Mr. Chairman, and I welcome you, Mr. Secretary and applaud your testimony.

It seems to me that we have elevated to at least a level of national consciousness unprecedented in the 15 years I have been here, a discussion of a Tax Code that is cumbersome, complicated, inequitable, unfair, filled with disincentives to capital formation and productivity. And yet, for all of that discussion, I am less sanguine than many that we are going to come up with anything that comes close to our rhetorical commitment to what we know are desirable goals.

It seems to me, though, in the debate that will ensue, it is worthwhile to examine some fundamental principles. First, we have those who embrace the concept of controlled economies, whether it is fascism with Government control of the means of production and distribution, or communism with Government ownership. That approach is opposed by those of us who really have faith in the capabilities of the people in the private sector to make infinitely better judgments about their own economic welfare than politicians, who can only muddle up the process.

In between, we have a constellation of people, many of them represented in our standing-room-only crowd here today who, because of what we have done to the Tax Code, are here to protect themselves against alterations that could have prodigious negative impact on them all.

We have also in this crowd, it seems to me—and I would liken these people probably to pragmatists and realists, who are trying to work with this system—we have intellectual mush-heads, who do not know really what the parameters of the debate are. Then we have some who recognize that the Tax Code is a downright good thing for them, and they want to take advantage at the expense of their neighbor.

Now, in looking over certain other premises our founding fathers had, one of the foremost was that government does nothing well, and I think all history bears that out. My own inclination is in the direction of Henry David Thoreau, who said the only positive thing government can accomplish is the alacrity by which it gets out of the way.

And I feel that in the debate, if we are truthfully going to explore the value of items like capital formation incentives, we must acknowledge, based on our entire historic experience, that those items have been good motivaters. They have given us the highest material standard of living in the world. And in that context, I applaud your willingness to consider alternatives above and beyond what Don Regan presented to us.

Don said at the time that we do indeed have a national industrial policy; it is our Tax Code. Don wants to achieve neutrality and let the people in the private sector make up their minds. Bob Dole, by contrast, says, "Look, I have greater confidence in the Tax Code providing the incentives than creating new programs."

I am not so sure he is right on that point, to be honest with you. It might be better if we were honest and candid about it and say, "OK, we are going to target this group, that group, what-have-you, for special legislation."

But let me just give you one example—and I am going to take advantage of the chairman's offer to submit a proposal in writing to you that, when you have the time, I would like to see some figures on it. But let's consider the first dollar we earn. If we follow all of the things that you and I counsel our kids to do, and that is, do not squander it as soon as you make it—put it into some savings or investment for delayed benefits at a later period, and that this is what makes the economy go—that dollar gets hit many, many times.

For example, if, say, I bought Seagram whiskey stock with it, the Seagram whiskey stock they are selling, and my dollar gets taxed if I buy any of it, with an excise tax, so that same dollar now has been hit twice; then, if Seagram shows a profit, it gets hit a third time when they have to pay taxes on the profits. When they make the dividend distribution, it gets taxed a fourth time. If I sell the stock, and it has appreciated in value, I pay capital gains tax on it, so it gets hit a fifth time. And then if I have the audacity to die and to stop being a productive taxpayer to this establishment, my poor widow and kids get hit with that final tax on that same dollar.

We have built within our code positive disincentives to savings by taxing interest, by taxing dividends, by taxing capital gains, and I would hope that you would be open to consideration in our broad tax reform discussion, of some positive action that would reward people, again, in this country for saving and would reward people for making positive investments in the growth of our economy.

I applaud you and the administration for acknowledging, too, that we know that the Government does not produce anything. It can only take from producers out there and then redistribute it.

And the second thing is the recognition that only individuals pay all of the taxes, either with their consumer hat on or their taxpayer hat on.

I look forward to working with you, Mr. Secretary, and applaud your statement and welcome a refreshing debate on this subject.

Secretary Baker. Thank you, Congressman.

[The following was subsequently received:]

PHILIP M. CRANE
MEMBER OF CONGRESS
12TH DISTRICT OF ILLINOIS

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SOCIAL SECURITY

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ROBERT C. COLEMAN
ADMINISTRATIVE ASSISTANT

March 19, 1985

Honorable James A. Baker III
Secretary of the Treasury
Department of the Treasury
Washington, D.C. 20220

Dear Jim:

It was a pleasure to hear your recent testimony before the Ways and Means Committee. I know we will have ample opportunity for further formal discussions. I hope we will also have the opportunity for informal and informational talks. I am looking forward to a positive working relationship during the years ahead.

What follows is the proposal I alluded to in my remarks to you, and I am taking advantage of your offer to respond.

On the subject of a flat-rate income tax, I would like an estimate of the single tax rate necessary to provide revenues equal to 18-to-19% of the GNP, if only earned income, fringe benefits, and dividends are taxable under the income tax formula. My proposal will have the following parameters which I would like you to include in your calculations:

* Elimination of all corporation taxes. All excise taxes, tariffs and customs duties paid by companies will remain as current law.

* Elimination of all taxes on savings and/or investment. This should include the elimination of the taxation of capital gains and interest.

* Elimination of all taxes on Social Security benefits.

* Elimination of all taxes on retirement income if that income has already been taxed once before.

* Elimination of inheritance and generation skipping taxes.

* The poverty level (established annually by the Director of the Office of Management and Budget) is provided as a threshold for a basic income exemption for each income earner. Thus, a working spouse would file separately to gain the basic income exemption.

> *Fringe benefits are considered to be any non-salary or non-wage benefit provided to the employee by the employer. The value of the benefit shall be the cost to the employer of providing that fringe benefit. Therefore, no cost benefits, such as free airline passes for stand-by only riders and parking spaces on company property, are valued as zero cost benefits.

Please provide an explanation of any assumptions used in completing your computations.

Given the above listed parameters, approximately how much does one percentage point above or below the proportional rate affect government revenues? In order to facilitate your calculations, I have enclosed a discussion draft of my proposed legislation.

If you have any questions concerning this request, please contact Harris Jordan or Ed Meyer of my staff. I look forward to your response.

Warm personal regards,

Philip M. Crane, M.C.

enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

ES 85-05923
Due 3-28-85

APR 29 1985

Dear Mr. Crane:

This is in reply to your March 19, 1985 letter to Secretary Baker, in which you request an analysis of your proposal for a single rate individual income tax, elimination of the corporation income tax, and various other changes in the tax structure.

We will be very happy to work together with your staff to analyze this proposal and, using our data, arrive at an estimate of the appropriate flat rate that would achieve your target to maintain receipts at 18 to 19 percent of GNP.

There are, however, two problems that prevent our carrying out that work at this time. First, my staff analysts are working full time to produce the tax reform and simplification recommendations the President will be sending forward to Congress next month.

Second, because your bill is in the "discussion draft" stage, there are many crucial details that need to be established before an accurate revenue estimate can be made. I believe you recognized this when you asked that we supply, with our analysis, an explanation of any assumptions used and when you offered staff contacts to answer our questions.

I hope you can understand our position. We look forward to working with your staff -- as we have in the past -- once the immediate pressure on my staff has subsided.

Sincerely,

/s/ Rca

Ronald A. Pearlman
Assistant Secretary
(Tax Policy)

The Honorable
Philip M. Crane
U. S. House of Representatives
Washington, D. C. 20515

	INITIATOR	REVIEWER	REVIEWER	REVIEWER		
CODE	OS/X		OS/D	OS/L	OS/X	EDIT
SURNAME	JGWilkins/jbw		RGDarman	MFeller	CEMcLure (in draft)	
INITIAL/DATE	4/22/85					

TD F 10-01.4 (8-73) replaces OS 3196 (2-75) which may be used

CORRESPONDENCE APPROVAL AND CLEARANCE

Chairman ROSTENKOWSKI. Mr. Downey will inquire.

Mr. DOWNEY. Thank you, Mr. Chairman.

I want to thank you for your very patient testimony. I have had the privilege of questioning you twice, Mr. Secretary, and I want to review a little of what you told me before the Budget Committee.

Twice, President Reagan has in press conferences said that this is the best thing he has ever seen. He reiterated that point in his State of the Union Address. In an interview in the Wall Street Journal, when asked specifically about business taxes, he said he was not that familiar with it.

Then, when I asked you the question if we somehow magically decided to take the Treasury proposal No. 1 in its entirety, passed it here and passed it in the Senate, and sent it on to the President, you said that he would not sign it.

Now, what I want to get in my own mind is what sort of a guideline the Treasury plan is for us—because you have already said today that you are not going to walk away from it, you do not propose to come off the Treasury proposal. And you have also said today that everything is on the table.

Now, if the Treasury proposal were a road map to New York, the mecca of tax reform, where would I wind up if I followed it? Would I wind up in Chicago? Would I wind up in Baltimore? How close would I get to what you are going to come up with if I am looking at that Treasury plan for guidelines in preparation for your May proposal?

Secretary BAKER. You would get to Philadelphia.

Mr. DOWNEY. All right, you would get to Philadelphia. Well, Mr. Coyne is in the room, so I will not say anything about Philadelphia.

Are we prepared to tell the American people that they can expect, if they earn under $50,000, that their rates will be lowered by a tax reform plan?

[Secretary Baker nodding head.]

Mr. DOWNEY. We are?

Secretary BAKER. Yes—if we get tax reform.

Mr. DOWNEY. If we get the tax reform that you are prepared to offer us.

Secretary BAKER. That is right, and that is in the President's State of the Union Message.

Mr. DOWNEY. Is Ronald Reagan prepared to tell the American people, and in particular, businesses in this country, that some of them will pay more taxes—a lot more taxes?

Secretary BAKER. He said that in his last press conference.

Mr. DOWNEY. So that we are at least sure of two things; that individuals will be paying less income tax as a condition of any reform——

Secretary BAKER. That is correct.

Mr. DOWNEY [continuing]. And that businesses will be paying more?

Secretary BAKER. I have said that today, too, Congressman.

Mr. DOWNEY. OK. Can I ask you, then, if there is other room—if, for instance, in the process of working through these proposals, we find that we do not want to change capital gains, we do not want to change ITC quite the way the Treasury proposal did, and that we want to do other things, and that the revenue that we are potentially going to get from business sources is less—would it be fair for us in this committee to look for other sources of revenue, assuming that we want to continue to keep individual rates low and moving down? Can we look, for instance, at an oil import fee, as a way of raising some of the lost revenue that we would not be providing with the Treasury proposals, assuming revenue neutrality?

Secretary BAKER. Well, I do not think the President would support that, Congressman. He would view that as a new tax. And I would hope that we could get there without resorting to new taxes.

Mr. DOWNEY. OK. The question of a new tax is also something that maybe we can define and you can help define for me. A new tax. If I am currently not paying tax and I have to now pay tax, is that not a new tax?

Secretary BAKER. Well, yes, you could so construe that, but it is not a new tax in the sense that it is a new levy on people who are now paying.

Mr. DOWNEY. OK. So we are foreclosing, and this administration is foreclosing, if the Arabs continue to lower the price of oil—as I certainly hope they do—the opportunity of keeping the rate of gasoline at a level and trying to take additional revenue to either help reduce individual rates or solve some of the other problems we might have with raising revenues.

Secretary BAKER. That is right, and particularly as a part of this tax reform effort.

Mr. DOWNEY. OK. Last, let me ask you about one specific item that you have gone over twice, and I do not mean to beat this to death. That is the R&D tax credit. It has been in all of the proposals before, and you alluded to the fact that you believe that one of the reasons it is there is because it does promote the sort of investment that leads us to being more competitive. Is that your personal view?

Secretary BAKER. Yes, sir.

Mr. DOWNEY. And is it likely that we will see it retained?

Secretary BAKER. Well, that is not a question for me to answer today. As I have indicated before, I am not going to go through each one of these items and say yea or nay on them.

Mr. DOWNEY. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Ford will inquire.

Mr. FORD. Thank you very much, Mr. Chairman.

Mr. Secretary, we do welcome you before the committee.

Secretary BAKER. Thank you, sir.

Mr. FORD. Mr. Secretary, I want to apologize for not being here when you gave your testimony earlier before the committee, but I have had an opportunity to look it over since I have been here, and hearing my colleagues raise certain questions to you.

One or two questions, Mr. Secretary. Are you communicating with your predecessor, the new Chief of Staff, Mr. Regan, on this particular tax matter?

Secretary BAKER. Yes.

Mr. FORD. I notice in your opening statement, you mention that all of the provisions are being reconsidered by your staff; you have instructed the staff to do so. Have you communicated with Mr. Regan in regards to reviewing all of the provisions in this tax proposal?

Secretary **Baker**. Absolutely. You know the background of the Treasury proposal. The background is that the President asked the Treasury Department to come up with various ways in which we could accomplish tax reform. They came up, I think, with three or four different methods. This is the one that my predecessor thought was the best, and the one that the Treasury Department then, as a department, sent over to the White House. The President never embraced it specifically. He said: "I want to review it in quite some detail before we take any sort of a legislative initiative with the Hill."

So, to answer your question, absolutely.

Mr. **Ford**. Are you receiving any signals from Mr. Regan as to what tax proposals ought to be included in this proposal, or proposals that you are going to submit?

Secretary **Baker**. So far, I have not. But let me say this. I would expect to receive signals with respect to every single item I bring up here from the President of the United States, and having been Chief of Staff at the White House, I know how that system works. So you can bet your life that there will be close coordination and cooperation between the Treasury Department and the White House in the development of the package we finally present to you.

Mr **Ford**. When you were Chief of Staff under the President, your position against taxing employee benefits was one that I think you had some opposition to as it relates to health benefits. As the Secretary of Treasury now, could you state your position on taxing employee benefits, especially health benefits?

Secretary **Baker**. I do not recall ever taking a position, Congressman Ford, as Chief of Staff of the White House, on the taxation of employee benefits, quite frankly. What my personal view is, really, is of no moment today. I cannot sit here today and tell you whether we will continue to include in the package we send to you the provisions that are now in the Treasury package, or whether we will modify them or delete them. I will say that there is significant opposition across the way to the taxation of fringe benefits.

I do think this, Congressman. If we are going to reform the Tax Code, and if we are going to reduce individual rates, we are going to have to look not only at the deductions and preferences that are now granted by the code, but at income that is paid that escapes taxation. And one of the biggest categories of that, quite frankly, is fringe benefits.

Mr. **Ford**. Mr Secretary, I have heard from a lot of groups and organizations in my hometown, which is Memphis, TN, dealing with charitable givings. And I notice in the proposal by your predecessor, Mr. Regan, when we talk about tax simplification, or simplifying the Tax Code, naturally, charitable contributions, the foundation of those charitable givings will be weakened at some point, if in fact that proposal would be adopted, or recommended and adopted by the Congress.

Could you state your position as it relates to simplifying the Tax Code as it relates to what will happen with charitable givings?

Secretary **Baker**. Well, we are in the process, as I said earlier, of taking a look at that right now. We are not confident that there will be significant adverse effects, but we want to make certain, because we do not want to destroy the concept of charitable giving in this country. We do believe that if everybody gets the kind of rate reductions we are talking about, that will encourage and stimulate giving.

Mr. **Ford**. And charitable contributions?

Secretary **Baker**. Yes, sir.

Mr. **Ford**. I have no further questions, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Campbell will inquire.

Mr. **Campbell**. Thank you, Mr. Chairman.

Mr. Secretary, I am delighted to see you here today.

Let me tell you from the beginning what my general concern is with the proposal as written by the previous Secretary and presented publicly, or perhaps he did the presentation, not all the writing.

I am concerned with capital formation, as other people have talked about here today. I am concerned with investment incentives, I am concerned with international competitiveness, I am concerned with jobs in the process of this. I am also concerned with revenue loss as we make some changes. Let me tell you, going down the line, what I feel.

As I have looked at it and talked to a lot of people about it, the cost recovery system that has been put into this proposal is less favorable than the cost recovery system and the other incentives that are offered to most of our principal trading partners. We do not operate in a vacuum in the United States. We compete. Now, this is not just an idle observation. Canada is now promoting movement there, and they are seeking that, and I am afraid that we may exacerbate the problem because of the fact that we, in fact, penalize the investment in this country, or do not provide the incentive for it, while at the same time, we encourage the sales, because of the individual tax rates here.

I am also concerned that the change in the Tax Code, as you propose, on capital gains, will not provide for investment incentives, and will not encourage risk capital. As a matter of fact, it will discourage it. And I do not think that we are neutral on investment with these proposals.

Even down to smaller things like loss of revenue, in your own estimate, the change in the capital gains would lose $135 million, and that is your estimate. In other items that sound good to the public, we have seen studies by Chase & Wharton and others who have said that things such as the business lunch deduction—which is something that Carter went after, and everybody is going after—all of a sudden, we see Chase telling us that will lose 140,000 jobs. And you know, we begin to ask questions as to what are we really doing as far as job creation, international competitiveness, and things of this nature are concerned.

I would just like to—and you have answered most of these things specifically as we have gone down the list—but I would just like to tell you that there are some things in here that we have not discussed—the targeted jobs tax credit, which has helped about 500,000 people in the last year, which we are zeroing out.

I would just like to ask you, has the Treasury worked up—and I have read your books, and I have seen all of these various estimates—but taking the exact proposal that you have, have you given us something as to whether we are going to hurt our international competitiveness? In fact, are we going to have the investment-led growth in the economy which we have had, because I happen to believe that what we did in 1981 with ACRS and things of this nature led the recovery in this country? If you go back and look, we had the most business investment since the 1940's, and this helped to pull it along. Have you analyzed overall the impact this is going to have on total job creation and business dislocation vis-a-vis other countries?

Secretary **Baker**. Well, on job creation, it is our view, Congressman Campbell, that it will generate jobs, and it will result in greater economic growth and more economic activity by virtue, primarily, frankly, of the individual rate reductions, which are substantial and significant.

We think, yes, ACRS and ITC and those other provisions have been important in terms of generating the expansion we are now enjoying, but we also think that the rate reductions of 1981 played a large part in that. We think that the rate reductions we could get here would tend to do that.

As far as disincentives with respect to trade, I have said several times today, and I have said, as a matter of fact, since my confirmation hearing, that we want to look at each and every one of the proposals that are in the Treasury package to see if they would operate detrimentally as far as affecting our trade imbalance or balance.

But, can I give you a study that has already been conducted, that we have gone out and ordered? The answer is no.

Mr. **Campbell**. But specifically—and my time is up—specifically, you have not done that as far as trade competitiveness or plant dislocation, things of that nature are concerned. Specifically, do I take it it is not the intent of Treasury to put things in this simplification or reform package that would act as an incentive to dislocate or as disincentive to job creation—is that a fair statement?

Secretary **Baker**. Yes, sir, but I do not think—I mean, there may be instances, there may be particular situations that you could point to and you could say, all right, now, if you are going to change—let's talk about ACRS for a minute—if you are going to change the system in this respect, it is going to have some disincentive. It is going to require some relocations or dislocations from what we are now enjoying.

My answer to you is that in some industries today, we are enjoying a negative income tax situation, by virtue of ACRS and ITC, and I happen to think that there is some room for us to do some things with respect to those deductions.

Certainly, if we are going to reform the Tax Code and reduce everybody's rates, including corporate rates, and give corporations a 50 percent dividends paid deduction, we are going to have to take a look at those. Now, in taking a look at them, we may accomplish some of the results that you and I agree would be unfortunate if looked at in a vacuum.

Mr. **Campbell**. Thank you. My time is up.

Chairman **Rostenkowski**. Mr. Russo will inquire.

Mr. **Russo**. Thank you, Mr. Chairman.

Good morning, Mr. Secretary—I guess it is good afternoon now. It is nice to see you again. I wanted to tell you this morning that we had David Stockman in front of us at the Budget Committee hearings, and he has indicated that 19 percent of GNP is the line of demarcation on any future tax increases, so that we can expect no other increases from this administration that take us above the 19 percent figure. Would that be an accurate statement?

Secretary **Baker**. I said the same thing here earlier, Congressman.

Mr. **Russo**. You must have compared notes on the way out.

Secretary **Baker**. For once, the administration is speaking with one voice.

Mr. **Russo**. That is great. Mr. Secretary, in this particular piece of legislation that we are developing, this revenue-neutral tax reform package, I believe the administration is going to be proposing one of the largest tax cuts in history while it also proposes one of the largest tax increases in the history of the country, so we come out with basically a revenue-neutral proposal. Is that how you look at it?

Secretary **Baker**. I suppose you could say that.

Mr. **Russo**. Alright. In dramatically altering the Tax Code in terms of what preferences we put in and what preferences we are going to take out do you have any idea at this point what you think are the least-defensible tax preferences, and which ones you would say are tax preferences that you would automatically consider would be part of the code?

Secretary **Baker**. Congressman Russo, that is something I ought not to do today, and that is something, quite frankly, I told the chairman I would not be ready to do today. If we have got any chance at all of bringing together a package, it will evaporate the minute we start selectively ruling one out and something else in.

Mr. **Russo**. But are we going to get a specific legislative proposal, or are we just going to get specific proposals you would be willing to support, but that the Congress will have to put into a bill?

I was not here, so I——

Secretary **Baker**. Yes, I know. Let me review it for you. We will know in 4 to 6 weeks whether we will come to you with detailed specifications, whether we will come to you with revisions to the current Treasury proposal in its current form, which is quite detailed—if you have read it, you know—or, whether we will come to you with specific statutory language.

We are not sure which of those three approaches, but in any event, you will have detailed specificity, and you will have the President of the United States, out front, supporting those changes.

Mr. **Russo**. And basically, those will be revenue-neutral when added altogether?

Secretary **Baker**. They will be revenue neutral.

Mr. **Russo**. OK. Mr. Secretary, in your testimony, you stated that any tax reform package should maintain incentives for capital formation. And I assume part of what you are referring to is ACRS. Now, you may have covered this before. But in last November's Treasury's analysis, they concluded the following, that ACRS has fueled the growth of tax shelters; created investment distortions which hamper economic efficiency; generated complexity; and added to the enforcement burden of IRS.

In light of those assertions in the Treasury's analysis of ACRS, are there any saving graces for keeping it?

Secretary **Baker**. Yes, there are some arguments that I think are fairly strong that one could make. But that is not to say that that is the route we are going to take because we really have not gotten there. But what we have got to do is take a look at ACRS versus other similar or competing methods of depreciation; see what we think that does with respect to capital formation and investment, and make a recommendation to you. And we plan to do that.

Those are the negatives with respect to it. There are positives.

Mr. **Russo**. I would like to see them. That is going to be part of whatever you prepare in the next 4 to 6 weeks?

Secretary **Baker**. We will make a determination whether to go with what the Treasury is now suggesting vis-a-vis ACRS; restore ACRS, or come up with something in between.

Mr. **Russo**. Mr. Secretary, one last thing, just to make sure that the administration is speaking with one voice. One of the comments that the Budget Director made this morning was that the original 1981 tax cut clearly went too far. The five 1982 to 1984 tax bills were therefore essential to restore the revenue base to at least the status quo.

Would you agree that the 1981 tax bill went too far?

Secretary **Baker**. I think the fact that we have had five bills in the interim argue strongly that that is the case, yes, sir. And I think the point the Budget Director was making, which I hope I made earlier here, is that the revenue base has been restored, and we do have revenues now at 19 percent of GNP. And from 1955 to 1980, we have had revenues at 18.6 percent of GNP. So people that argue that taxes are too low, in my view, are not persuasive.

Mr. **Russo**. Well, part of what I was not able to follow up, because my time ran out, but what I see right now, is that it seemed to me that the original plan of this administration was to dry up revenues through a very expansive tax cut and then come back and ask for budget cuts in areas where they wanted cuts and obviously were unable to do so, and we got five tax increases, which was the biggest secret in the 1984 election, that President Reagan did support and push tax increases.

Secretary **Baker**. Well, if you are asking me can you get spending cuts when you are talking about tax increases, the answer is, obviously, no. It is always easier to raise taxes than it is to cut spending. That is why we are not going to entertain any discussions of tax increases, because frankly, the President feels strongly that the American people are not undertaxed, and that it is the spending side that has got to be addressed, and that that is what the election said.

Mr. **Russo**. I thank you, Mr. Secretary.

Chairman **Rostenkowski**. Mr. Frenzel will inquire.

Mr. **Frenzel**. Thank you, Mr. Chairman, and thank you, Mr. Secretary.

The visit has been a long one, but I think it has been very helpful for the committee. I have some thoughts which I will articulate, and leave you to comment on them either for the record or in person. Some of them deal with things that you have already gone over.

It seems to me that the problem is a tough one. I am not one of the superenthusiasts. If I were, I guess, like Mr. Gephardt, I would urge you to get out on a date-certain and speed it up. Since I am not, I urge you to do it right, rather than to do it fast, and if it takes you an extra day or two, take the time. This process is not going to gallop along, anyway. And that is simply a matter of advice.

Then, I would raise some of the questions that some of the other members did about revisiting areas where we have been before, very recently.

Mr. Stark and Mr. Moore made their strong pitch. I suppose that Mr. Downey and I might do the same with respect to the tax-exempt bond issues of various kinds. And then, after we decide what we want to revisit, you of course will have already decided what you think is necessary, and you have already outlined some of those things—the capital formation incentives that have to be put back in—and then we here will find some things that we think are too attractive to repeal, and my guess is that many of those will deal with the personal deductions, the State taxes which Mr. Rangel mentioned, plus health and welfare and charities, which other people have mentioned, et cetera.

Then we are going to find some other things that are gray areas, like the foreign tax credit, and there we need your help. This committee cannot do much about the Export Administration Act, or Ex-Im Bank financing, or the Foreign Corrupt Practices Act. Our only stimulus for export is in section 911 and the foreign tax credit. And you can help us there, I think, by guiding us along and helping us use our corner on that problem correctly.

And finally, just a thought about progressivity. If what I suggested is correct; that is, we wind up supporting the things that you want, which is homeownership incentives, and some of the things that were mentioned today, we are going to be not only lowering marginal tax rates, but retaining a number of individual deductions, and we are going to find ourselves probably in a position where we are lowering our own personal tax rates substantially and perhaps raising them for others. And I think the progressivity question has not been mentioned here. We are anxious to lower taxes at the margin, and I am, too, but I do not desert whatever tax policy basis I have for feeling that people who have a little more money should pay a little bigger proportion of their earnings than those who have less. I think that needs to be considered, too.

We are anxious to work with you through this difficult problem, and it is going to be a long and difficult trail, but I hope that we are all successful, and we really appreciate what you are doing to move this along.

Secretary **Baker**. Thank you, Mr. Frenzel.

Chairman **Rostenkowski**. Mr Moore will inquire.

Mr. **Moore**. Thank you, Mr. Chairman.

Mr. Secretary, I want to welcome you in your new job and welcome you in your first appearance before our committee and tell you that I have been an admirer of yours for many, many years, and know you can do an outstanding job, and also commend you on the work you are undertaking. I think it is of vital importance to the future of the country.

We have a saying down South that "You can eat your seed corn." And if we have a Tax Code that is disturbing where investment capital ought to go in this country, it provides exactly what we are doing—we are eating our seed corn and keeping it from going where it ought to go.

Our distinguished chairman made a speech recently to the Economics Club of New York, pointing out in his speech the problem with foreign capital; that we have it now, it is helping us finance our deficits, and when that leaves, we are in real trouble. I agree with him whole-heartedly, and I know that you do.

My concern is we are not doing enough to create additional capital formation in this country. We are concerned that anything in this tax report that lessens the aggregate amount of capital investment in a country ought to be viewed very carefully, and I know that you will. But in particular—in particular, I am of the opinion that anything we can do to increase the saving rates in this country, we should do. Most economists that have come before this committee have told me that if you get an increased dollar in savings, that offsets a dollar of deficit spending, because you are increasing the amount of capital, and therefore you do not have the pressure on the interest rates. We have tended to overlook that. In the battle against deficits, we talk about just reducing spending, which I agree has to be done, and some people talk about raising taxes, which I disagree has to be done, but nobody talks about increasing capital.

Last year, we had a provision that came out of this committee in the tax bill, that got scrapped at the last minute due to the lack of support from the Treasury Department, to allow nondeductible contributions to individual retirement accounts.

I am very pleased to see the Treasury report does talk about increasing the deductible from $2,000 to $2,500 for individual retirement accounts, and I want to encourage that very strongly. Senator Roth and myself have coauthored last year and this year a flat tax bill that goes even further in terms of savings incentives within the tax framework of a flat tax, such as the Treasury report is, to help encourage long-time savings. Recent figures I am receiving now from the Library of Congress on what is happening to individual retirement accounts are extremely interesting, where we are now finding that 63 percent of the tax returns that now have IRA's are from taxpayers that make less than $40,000 a year; 78 percent, less than $50,000 a year, and even more interesting is that something like 12 percent of all the IRA money, some $3 billion, is coming from people with between $10,000 and $20,000 per year income. So this is working. It is getting the lower middle income and middle-income groups back into saving long term.

So Mr. Secretary, I would just ask you for a comment on that and would hope you would hold fast on this and maybe even be able to do a little bit more to help us create more capital in this country.

Secretary **Baker**. Well, Congressman Moore, all I can say, frankly, is that again, from day one, since I have been in this job, I have said that we want to look at each and every one of these provisions to see what it does, not only with respect to capital formation and investment, but savings, as well.

And clearly, we want to encourage savings in this country, and I can only promise you that we will take a look at not only what is in the proposal now, but any other suggestions which you might have in formulating the package we come up here with.

I feel constrained to comment a little bit about the foreign capital comment that you made. Yes, it is true that we have foreign capital in this country. It is not so much that there has been an increase of foreign capital as there has been a significant increase in the repatriation of U.S. capital. Our banks are no longer making loans to Latin America, and frankly, the foreign investment, or investment by foreigners, if you will, in this country is not significantly greater today than it was in 1984, in 1983, or in 1982. But U.S. investment abroad is significantly down, so the net foreign investment—net foreign investment—is considerably higher.

Mr. MOORE. Well, certainly, we do not want that capital to leave precipitously, but we have got to be concerned about one day if it does, where are we, and we know we are going to be in tough shape in terms of the capital markets.

One last question. Is it your opinion—I think you may have been asked this—that tax simplification, if we can enact it, will in fact not be revenue neutral, as you will increase the amount of taxes being collected that is owed now, part of that $100 billion a year that nobody is paying, we will be able to get a chunk of that just through tax simplification?

Secretary BAKER. Well, there are strong arguments to that effect. When you simplify the Tax Code, you are going to broaden the base, you are going to increase collections, and you are going to increase compliance. In our proposal, we are not making any wild assumptions out there about the fact that we are going to pick up additional revenue just simply as a consequence of simplification. But many people will argue very strongly, and I think there is a basis for that, that you will indeed pick up some revenue.

Mr. MOORE. And we also would have additional IRS agents available, hopefully, through tax simplification, who will be able to help enforce it.

Secretary BAKER. Well, we have a proposal in, as you know, to add agents in each of the next 3 fiscal years.

Mr. MOORE. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Thomas will inquire.

Mr. THOMAS. Thank you, Mr. Chairman.

Congratulations, Mr. Secretary.

We now know that from the inner workings of the Supreme Court, the senior members get to argue the points first and then, after all the easy points are used up, the more junior members have to figure out what to say. But then on the voting in the closed chambers, it starts with the least senior members and goes to the senior members. I do not get either of those benefits here, and I know that the Secretary, based upon our past working performance, knows that we stand ready to cooperate on a bipartisan basis to answer as many of the questions facing this Nation as we can possibly answer in the shortest period of time?

I have a lot of particulars. They will come out as we get into the various programs, and I am not going to take his time or the committee's time in terms of trying to skate lightly over an area in which we are going to have to spend an awful lot of time in very specific subjects.

I do want to commend the chairman as well for his statement about this being a tax-writing committee, and we ought to get on with our business. I know the Secretary feels the same, and I look forward to working with him, and I thank him for being here.

Secretary **Baker**. Thank you, Congressman.

Chairman **Rostenkowski**. Mr. Secretary, I think this has been a very worthwhile exchange. I am happy that I insisted that you join us here today. I would like to make some observations in conclusion.

Secretary **Baker**. May the record show I am not here under subpoena?

Chairman **Rostenkowski**. I might make some observations in response to Mr. Thomas' dilemma. We could start the rollcalls with the junior members and the Republicans in the committee, if that will accommodate Mr. Thomas. Then we will know where everyone is right in the beginning.

Mr. Secretary, I am pleased that we have a joint purpose, that the Committee on Ways and Means and the administration will work together toward what I feel will be legislation that truly will be fair.

I must admit that those of us on our side of the aisle are a little leery and concerned. There was a feeling for a while that maybe the President and the administration would play the harp for tax reform while they send the Congress into the trenches to fight the war for it. I think that atmosphere is dispelled. I am hoping that you can be back with us as quickly as possible.

There was an observation made here that I agree with wholeheartedly—that there is a momentum, generated by the popularity of the President of the United States. I think that the longer we wait, the more forces will amalgamate against a revenue-neutral bill.

I look forward to working with you, as I am sure all my colleagues on the Ways and Means Committee look forward to working with you. I hope that when we do write the tax bill, that you will be seated right where you are today, and that you will give us the sage advice and counsel that you have expressed today.

I want to add that we look forward to some leadership from you as to what should be done with things like the cigarette tax and other measures that are scheduled to expire this year.

Having said all that, Jim, I am happy that you are sitting where you are. I feel a lot more comfortable because with your sincere effort, we can accomplish the objective of fundamental tax reform. I suggest that we try to do it as quickly as possible.

Secretary **Baker**. Thank you, Mr. Chairman.

May I say on behalf of the administration that we certainly welcome the spirit of your speech to the Economic Club of New York. I think that you made some of the same points and embraced some of the same themes that the President has spoken to when he has talked to this general subject. We look forward to working with you.

Chairman **Rostenkowski**. Thank you.

The committee stands adjourned.

[Whereupon, at 1:05 p.m., the hearing was adjourned.]

[The following was subsequently received:]

April 25, 1985
Paul Wilson
535-6962

TREASURY RESPONSE TO QUESTIONS (FROM WYCHE FOWLER) CONCERNING PROPOSED LIMITATIONS ON DEDUCTIONS FOR BUSINESS MEALS, ENTERTAINMENT, AND TRAVEL EXPENSES

General comment:

This is in reply to your March 13, 1985 letter in which you requested further information concerning the proposed limitations on the deductibility of business expenses for meals, entertainment, and travel.

I understand the importance of these proposals to the affected industries. We are concerned, as you are, that we take into account correct facts and that we make reasonable assumptions. For this reason, we have met with industry representatives and solicited their analysis of our proposals. As noted below, we have some degree of response, but such response has generally ignored the positive effects of other sections of the overall plan.

These proposals are part of a comprehensive tax reform proposal. To be useful, a study of the proposal's impact on a particular industry should take the other proposed changes into account. Lower tax rates, partial relief from double taxation of dividends, the elimination of tax on the inflationary component in capital gains -- these and many other elements would benefit the restaurant and hotel industries. Analyses that totally ignore them will yield misleading results.

Answers to specific questions:

1. We have received no comprehensive response from the convention industry. However, most of those attending large conventions are not subsidized at rates in excess of the proposed caps. Moreover, there are other parts of the proposed tax reform package that would benefit the convention industry.

2. The National Restaurant Association commissioned a study by Chase Econometrics, which examines the potential impact of several tax reform proposals. Unfortunately, that study was designed to estimate the impact of a proposal like that made by the Carter administration in 1978 (disallowance of a flat percentage of the cost of business meals). Using their model to estimate the impact of our much different proposal (disallowance of costs in excess of a cap) requires broad assumptions, as they indicate on page B-2 of their report.

Moreover, the Chase study assumes that this change is being made in isolation, with no other changes in the tax Code, whereas our proposal must be evaluated as part of a full tax reform package. While the proposal would reduce the demand for expensive meals, the demand for moderate-priced meals would increase. (The proposed cap would provide a strong incentive to replace expensive meals with moderate-priced meals. Moreover, for most taxpayers, restaurant meals are not subsidized. The elimination of other preferences from the tax Code will increase the relative demand for such currently unsubsidized forms of consumption. For these reasons, we have stated that "it is doubtful that aggregate employment in food service will decline at all as a result of the Treasury proposal." (Tax Reform Report, November, 1984, Vol. 1, p. 85).

The Chase Econometrics' study does provide additional support for our earlier estimate that less than 15% of all business entertainment meals have costs in excess of the proposed caps. Since business entertainment meals comprise approximately 20% total sales of U.S. eating and drinking establishments, only approximately 3% of all expenditures on such meals would be affected.

3. Although we have received estimates of job loss in the hotel convention industry from union representatives, we have obtained no explanation of their method of estimation. Moreover, the estimates apparently take no account of other elements in the tax reform package.

FUNDAMENTAL TAX REFORM AND OTHER TAX ISSUES

TUESDAY, MARCH 26, 1985

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman ROSTENKOWSKI. Ladies and gentlemen, this morning, we begin taking fundamental tax reform testimony from congressional authors. I hope these hearings will ultimately culminate in tax reform legislation. I can think of no one more suited to share sage advice about tax simplification, fairness, and reform than our colleague from California, Mr. Stark. It is my pleasure to welcome our colleague.

Mr. Stark, if you are ready to proceed with your testimony, the committee is ready to receive it.

STATEMENT OF HON. FORTNEY H. (PETE) STARK, A REPRESENTATIVE IN CONGRESS, FROM THE STATE OF CALIFORNIA

Mr. STARK. Thank you, Mr. Chairman.

I want to thank both you and our ranking minority member, Mr. Duncan, for proceeding with the difficult task of tax reform.

I guess I found out when I woke up in the hospital, and knew that my mother wanted a girl, that I was the second choice and, being here this morning, nothing has changed in 53 years.

But I am testifying today on the Base-Broadening Tax Act of 1985, H.R. 1377.

This legislation, as you and our members know, makes across-the-board reductions in all existing tax expenditures. Senator Chafee has introduced similar legislation in the Senate.

At first blush, this legislation does not look like comprehensive tax reform—and it is not. It raises revenue of approximately $178 billion over the next 5 years and does not eliminate any of the existing tax expenditures from the code.

We will hear testimony today on several comprehensive tax reform proposals. I support the Treasury proposal and/or the Bradley/Gephardt proposal. I am very impressed by the breadth of the Treasury's tax reform proposal which responds to most of the criticisms of our current tax system. The Treasury proposal produces a simpler, lower rate system that distributes the tax burden more evenly, and I have been an early and vocal supporter of that proposal. If the President gives strong and active support for the proposal, we may have a chance of passing some version.

My proposal, as currently introduced is not tax reform. And as such, I would view mere passage of my proposal without additional changes as not responsive to the public outcry for reform.

My bill proposes a temporary, across-the-board reduction in tax expenditures. Individual itemized deductions would be reduced by 10 percent, and all other tax preferences would be reduced by 20 percent. This legislation attempts to be as broad as possible. It reduces the investment tax credit by 20 percent, stretches out depreciation by 20 percent, and carries these reductions through to most of the other provisions in the code. I have attached for the committee a more detailed description of each area of the proposal.

However, the Treasury proposal, as well as the other reform proposals, present problems that I think the Stark/Chafee bill addresses. The question with which I grapple is not whether we should implement the Treasury proposal; as I said, I think we should; but how quickly we can bring about such a dramatic change which will affect all of the business proposals, and business procedures that this country now knows, and what we do in the interim with the Federal deficit. We all know the inequities and questionable incentives in the current code; yet we are also aware that an enormous amount of economic activity in this country centers around its provisions—indeed, may have been created by the code. You just have to look at the Washington Post article this weekend. The timber industry—and I speak as a person who used to be director of a publicly-owned timber company—could not exist, or would not exist, in its present form without the incentive built into the Tax Code.

What the Post article does not really cover is what would happen to that industry if we took the incentives away overnight and how quickly the industry could respond to that kind of dislocation.

The Stark/Chafee bill provides the vehicle to solve this fundamental problem and all the reform proposals. It is a good vehicle for starting the process of reducing the value of the innumerable, often contradictory incentives and subsidies that are in the code. We cannot abruptly rearrange long established economic relationships. The Tax Code is now an enormous rat's nest of incentives. The economy is honeycombed with industries and decisions directed or heavily influenced by the Tax Code. This situation has long been in the making and cannot be changed overnight without creating bankruptcies and losses affecting millions of people. Stark/Chafee can easily be adopted to provide a phased down reduction of tax expenditures; a reduction in benefits of 20 percent each year, for example, would eliminate the expenditures over 5 years and would allow an industry the time to adopt to a free market environment.

A second flaw in the other pending proposals is the possibility—or the impossibility, really—of raising any revenue. I know the chairman has stated, the President has stated, and most of the members of the committee have said that tax reform ought to be revenue neutral. That does not deal with the possibility that we may be mandated in this committee to raise some revenue. I know it is unpopular to tell the public that "the emperor has no clothes," but the President raised the issue of "Saturday Night Live" fodder and said "Go ahead and make my day." But the harsh reality is that we are facing an enormous deficit that is growing at the rate of $4 billion a week. I will not repeat the litany of dangers from an enormous deficit, but I will only suggest that if we cannot reduce spending sufficiently—and the President's latest comments on military spending lead me to believe we may not be able to—we may be forced in this committee, by the actions of our colleagues in the House of Representatives, to raise additional revenue.

If we pass a revenue-neutral tax reform bill, a process that at best will take us into next year, we may preclude raising any revenue for several years.

Once we set new rates, for example, the Members in the House would be unwilling to raise them for fear of being accused of perpetrating a fraud on the public by promising them a revenue-neutral tax reform bill and then having to turn around 1 year later and jack the rates up.

I just do not believe we can promise the American people that we can go several more years without any additional revenue, while at the same time, commit to substantially reducing the deficit. Stark/Chafee is extremely progressive, either as a revenue enhancer or as a rate reduction mechanism. If it is used to raise revenue, the tax burden is distributed by this proposal in a progressive manner. For example, individuals with incomes of $30,000 to $40,000 would have an increase of $285 in their taxes. If you are in the $100,000 to $200,000 category, you have an increase of about $2,400. It would in fact preserve the progressivity, which has also been a keystone of the chairman's requirement for fair tax reform.

Of equal importance, the 60 percent of all Americans who file a short form would not be affected at all, since the Stark/Chafee proposal would not reduce either personal exemptions or the zero bracket amount. If used to reduce rates, the revenue generated could also substantially reduce rates, the revenue generated could also substantially reduce individual rates.

The proposal has one other great advantage: It is simple. It is 25 pages as opposed to 1,000 pages, and I think that says it all.

As I stated at the beginning of my statement, I strongly and truly prefer fundamental tax reform such as Bradley/Gephardt, or what has been known as Treasury I. I offer my legislation as a proposal that is adoptable and flexible and which I hope can be considered in conjunction with these other proposals to lower rates and bring greater equity to our code.

I would like to close by applauding the efforts of you, Mr. Chairman and of Mr. Duncan, to say that we are going to face the tough reality of tax reform. I have pledged to you, and I want to renew that pledge publicly today, that if this committee continues to go ahead with broad-based tax reform, everything should stay on the table. I am not so silly as to introduced a bill that would eliminate charitable deductions and stand alone in front of all my colleagues and be defeated next term. But I have also told the charitable institutions that, while I am not introducing a bill to take away their deduction, if we are going to do broad-based tax reform, they are in the room with everybody else. And I hope that the other members of the committee and the other Members who testify here this morning will renew their pledge to you to see that we are willing to stand up and face the tough battle that you are going to have to take publicly. I want to commend you for beginning this effort. I am proud to be the leadoff witness in what I hope will be a rapid and thorough revision of the Tax Code under your leadership.

Thank you for the privilege of testifying this morning.

[The prepared statement and attachments follow:]

STATEMENT OF HON. FORTNEY H. (PETE) STARK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

I am testifying today on the Base Broadening Tax Act of 1985, H.R. 1377. This legislation, as you know, makes across-the-board reductions in all existing tax expenditures. Senator John Chafee has introduced similar legislation in the Senate. At first blush the legislation does not look like comprehensive tax reform. It raises revenue of approximately $178 billion over the next five fiscal years, and does not eliminate any of the existing tax expenditures from the code. We will hear today testimony on several comprehensive tax reform proposals, some of which, such as Bradley-Gephardt, I support. I have also been very impressed by the breadth of the Treasury's tax reform which responds to most of the criticisms of our current system of taxation. The Treasury proposal produces a simpler, lower-rate system that distributes the tax burden more evenly. I have been an early and vocal supporter of the Treasury proposal and if the President even gives strong and active support to the proposal we may have a good chance of passing some version of such a proposal. My proposal, as currently introduced, is not tax reform, and as such I would view mere passage of the proposal without additional changes as not an answer to the public outcry for tax reform.

My bill proposes a temporary across-the-board reduction in tax expenditures. Individual itemized deductions would be reduced by 10 percent and all other tax preferences would be reduced by 20 percent. The legislation attempts to be as broad as possible. It reduces the investment tax credit by 20 percent, stretches out depreciation periods by 20 percent, and carries these reductions through to most of the other provisions in the code (a more detailed description is attached).

However, the Treasury proposal, as well as most of the other reform proposals, present certain problems which I think Stark-Chafee addresses. The question with which I grapple is not whether we should implement the Treasury proposal—I think we should—but rather how quickly we can bring about such a dramatic change and what we should do in the interim with the enormous Federal deficits.

We all know the inequities and questionable incentives in the current code, yet we are also aware that an enormous amount of economic activity in the country centers around provisions in the tax code. This weekend, for example, the Washington Post ran an excellent front page article on the timber industry. It chronicles the special capital gains rate and other incentives that have directed the timber industry for decades. It points out that many of these incentives may be unnecessary and that the industry, while highly profitable, pays almost no corporate income tax. It is just this type of situation that fundamental tax reform is intended to address. What the article does not really cover is what would happen to the industry if all the incentives were removed overnight and how quickly the industry could respond to the dislocation. Stark-Chafee has the ability to solve this fundamental problem. It is a good vehicle for starting the process of reducing the value of the innumerable, often contradictory, tax incentives and subsidies. We cannot abruptly rearrange long-established economic relationships. The tax code is now an enormous cat's cradle of incentives. The economy is honeycombed with industries and decisions directed or heavily influenced by the tax code. This situation has long been in the making and cannot be changed overnight without creating bankruptcies and losses affecting millions of people. Stark-Chafee can be easily adapted to provide for a phase-down reduction of tax expenditures. A reduction in benefits of 20 percent each year, for example, would eliminate the expenditures over 5 years and would allow the industry the time to adapt to a free market environment.

The second fundamental flaw of the other pending proposals is their revenue neutrality. I know that it is extremely unpopular to tell the emperor that he has no clothes. The President has taunted us with such "Saturday Night Live" fodder as "Go ahead and make my day," but the harsh reality is that we are facing an enormous budget deficit that is growing at the rate of $4 billion a week. I will not repeat the litany of dangers from an enormous budget deficit. I only wish to point out that if we cannot reduce spending sufficiently—and the President's latest comments on military spending leads me to believe that we may not be able to—we may be mandated to raise additional revenue.

My concern is that if we pass revenue neutral tax reform—a process that at best will stretch into next year—we will effectively preclude revenue raising for several years. Once we set new rates, Members will be unwilling to raise them for fear of being accused of perpetrating a fraud on the public by promising a revenue neutral tax reform but then turning around and raising rates. I just don't believe that we can promise the American people that we can go several more years without any additional revenue while, at the same time, commit to substantially reducing the deficit.

Stark-Chafee is extremely progressive, either as a revenue enhancer or as a rate reduction mechanism. If used to raise revenue, the tax burden is distributed by this proposal in a highly progressive manner. For example, individuals with incomes of $30,000 to $40,000 would have an average increased tax liability of $285 or a net tax liability change of 4.2 percent. Individuals in the $50,000 to $75,000 range would have an average tax liability increase of $523 or a net tax liability of 5.4 percent. Individuals from $75,000 to $100,000 would pay $1,053 in additional taxes or a net tax liability change of 6.3 percent. In the $100,000 to $200,000 class, the additional tax would be $2,346 or a net tax liability change of 7.6 percent. For individuals earning over $200,000, the average tax increase would be $19,448 or a net tax liability change of 13.1 percent. Of equal importance, the 60 percent of All Americans who file the short form would not be affected, since Stark-Chafee would not reduce either personal exemptions or the zero bracket amount. If used to reduce rates, the revenue generated could also substantially reduce individual rates.

The proposal has one other great advantage—simplicity. The bill is less than 25 pages long, a far cry from 1000+ pages that we inserted in the code during each of our two most recent tax bills.

As I stated at the beginning of my statement, I strongly prefer fundamental tax reform such as Bradley-Gephardt or Treasury. I offer my legislation as a proposal that is adaptable and flexible and which I hope can be considered in conjunction with these other proposals to lower rates and bring greater equity to our tax code.

SUMMARY OF STARK-CHAFEE LEGISLATION

It would reduce by 10% the value of individual itemized deductions. For example, only 90% of an individual taxpayers charitable contributions, home mortgage interest and state and local taxes would be deductible.

On the business side, ACRS deductions would be cut back on property placed in service during the period covered by the bill. Only 80% of the property could be depreciated under the regular schedules. The otherwise depreciable 20% would be depreciated by using the tax-exempt use property rules (e.g., 40 years for real property).

Other business deductions would be cut back by 20%. Included are those claimed for business entertainment expenses and convention facilities R&D expenses, intangible drilling expenses, untaxed earnings and profits of controlled foreign corporations, foreign sales corporation benefits, and incentive stock options.

All tax credits would be reduced by 20% including investment tax credits, energy credits, and the R&E credit as well as the individual tax credit for child care.

Exclusions subject to the 20% reduction include those for long-term capital gains, foreign earned income of U.S. citizens abroad and the one-time exclusion on the sale of a personal residence. The 20% reduction for long-term capital gains would reduce the current 60% exclusion to 48%, for a maximum tax rate of 26%.

Dollar limitations are reduced 20% on such diverse items as the pension plan contribution limits, the luxury car limit, and the maximum IRA contribution and deduction amount.

The volume caps for mortgage subsidy bonds and industrial development bonds (IDBs) are also scaled back by 20%.

The alternative minimum tax rate is increased to 26%, assuming the top individual rate stays at 50%.

Revised Stark-Chafee proposals.—The current Stark-Chafee proposals are more comprehensive. Unlike last year, the new bills propose an increase in the rate of the alternative minimum tax and would also reduce the benefits of the corporate liquidation nonrecognition provisions. The provision to reduce by 20% the limitation on the net operating loss deduction has been dropped.

Revenue effects.—Over the next five fiscal years, Representative Stark's bill proposes to raise $178 billion while Senator Chafee's bill would generate $168 billion.

For fiscal year 1980, individual preference cutbacks under the Stark bill would yield $30 billion, a 5.8% increase in individual tax receipts. On the corporate side, corporate preference cutbacks would yield $22 billion, a 20.6% increase in corporate receipts in contrast, the Chafee bill represents a 6.2% increase in individual tax receipts at $32 billion. Corporate preference cutbacks would yield $16 billion, a 14.95% increase in receipts.

Distributional income effects.—The distributional effects of Senator Chafee's broad base plan appear below. The table indicates that the tax burdens are distributed in a highly progressive manner. Representative Stark's plan would similarly distribute its tax burdens.

ESTIMATED REVENUE EFFECTS OF THE STARK PREFERENCE CUTBACK PROPOSAL—FISCAL YEARS 1986–90

[Billions of dollars]

Item	1986	1987	1988	1989	1990
Basic preference cutback proposal:					
Individual	3	22	25	27	30
Corporate	5	11	15	18	22
Total	8	33	40	45	52
Additional fringe benefit items [1]	4	6	6	7	8

[1] Employer-paid health plan premiums, employer-provided group term life insurance, and employer-provided dependent care assistance.

DISTRIBUTIONAL EFFECTS OF CONGRESSMAN STARK'S BROAD BASE TAX PLAN

Expanded income classes (actual)	Tax increase: Returns (thousands)	Tax increase: Amount (million)	Tax increase: Average (actual)	Percent of total distribution	Percentage change in tax liability
$10,000	2,759	$64	$23	0.5	1.7
$10,000 to $20,000	7,912	542	69	4.1	1.9
$20,000 to $30,000	9,954	1,217	122	9.3	2.7
$30,000 to $40,000	8,009	1,553	194	11.8	3.7
$40,000 to $50,000	5,012	1,429	285	10.9	4.2
$50,000 to $75,000	3,408	1,781	523	13.6	5.4
$75,000 to $100,000	813	857	1,053	6.5	6.3
$100,000 to $200,000	695	1,629	2,346	12.4	7.6
$200,000	207	4,034	19,448	30.8	13.1
Totals	38,769	13,106	338	100	5.2

Note.—Table reflects major items affecting individuals: the alternative minimum tax, the capital gains exclusion, itemized deductions (charitable contributions, interest paid, taxes paid, medical expenses, casualty and theft losses, etc.), the dependent care credit, and the dividend exclusion. Table represents effects of proposal under 1986 tax law at 1983 income levels (i.e., the table indicates what the distributional impact of the proposal would have been if implemented in 1983 on a calendar year basis). The percentage change in tax liability for an income class equals the increase in tax liability for the class (as a result of the proposal) divided by the total tax liability for all the returns in the class under present law.

Chairman **Rostenkowski**. Thank you, Mr. Stark. I could not agree with you more. The minute that we start winking at one favored preference or another, I think we lose the whole opportunity for serious tax reform, where the ingredient of fairness is the centerpiece. I think we make a big mistake.

Are there any questions of Mr. Stark?

Mr. **Duncan**. Mr. Chairman.

Chairman **Rostenkowski**. Mr. Duncan will inquire.

Mr. **Duncan**. Mr. Chairman, I would like to compliment our colleague. I think he is a pioneer in this suggestion he has made, and there is some interest floating around on your proposal. I recall when you raised it about a year ago, and I think it is one of the many things that should be examined, and I thank you for all the effort that you have put into it. I glanced through the addendum attached to your statement, and I found some answers that I was particularly interested in.

I thank you so much.

Mr. STARK. I thank the gentleman from Tennessee, and I look forward to working with him on this project in the months ahead.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Mr. Chairman, I also would like to commend our colleague. He has been long a force for progressive thought on this committee, and this bill shows that this year is going to be no exception.

I particularly commend him for raising the concern about reform versus revenue increases. It is desirable, I think, to keep tax reform revenue neutral, but we cannot forget that at some point, we are probably going to have to raise some revenue to deal with these deficits, and it would be a mistake, as you point out, for us to preclude revenue increases along the line by what we do in tax reform.

Also, I thought your comments were right on target about keeping everything on the table when we deal with tax reform.

Unfortunately, a lot of interest groups tend to take the position that if you do not make them an absolute promise in blood not to touch them, that must mean you really want to go after them. I keep trying to emphasize to them that just because in this case, you refuse to take something off the table, that does not mean you have any ulterior motive and are really out to get them.

I think it is very important that all of us on the Ways and Means Committee try to avoid commiting ourselves to keep anything at all off the table.

I commend you very much.

Mr. STARK. I thank the gentleman for his comments.

Chairman ROSTENKOWSKI. Mr. Anthony will inquire.

Mr. ANTHONY. Pete, I think you have an excellent point. You said it was not tax reform, but it is backdoor partial tax reform.

But what bothers me is this. When you start taking away across the board, 10-percent, 20-percent credits and preferences, how do you justify, if there is a justification for some of these credits and preferences?

Mr. STARK. You do not, and that is one of the things that is wrong with my proposal, where the Gephardt/Bradley or the Treasury proposal is far better. The Stark/Chafee proposal really tends to exacerbate some of the inequities in the code. Although it reduces expenditures and raises some revenue, there are some further dislocations built into mine. You might like them better or worse, but that is why I say it is really not reform. It is a method to crank in reform, or a method to raise some revenue that is maybe politically more palatable than it is philosophically. But you touch right on the weakness. As a reform proposal, it fails on that count.

Mr. ANTHONY. I would just like to close with a very parochial statement. I happen to represent a State that is very big in the timber industry.

Mr. STARK. Not, however, I might add, so big on national forests, as some other States that I know.

Mr. Anthony. Well, in my area, we do not depend on the national forests. In your statement you indicated how highly profitable the timber industry is presently. I would like to go down and show you some of the financial statements of various timber companies in Arkansas that may show you that this is not necessarily true across the board.

Mr. Stark. Thank you.

Mr. Anthony. Thank you, Mr. Chairman.

Chairman Rostenkowski. Mr. Schulze will inquire.

Mr. Schulze. Thank you, Mr. Chairman.

I, too, would like to thank our colleague and just have two brief questions.

Pete, what would happen with your proposal if you wanted to lower rates. That is the first question, how much could you lower them. And the second question is what would the impact be on small business. Are there small, marginal businesses to whom 20 percent would be very important?

Mr. Stark. Dick, in answer to your first question, if my proposal were going to be revenue-neutral, then I would be chagrined if that was the result of it. But you could get the rates down to around in the low 40's, say 44, 43, and——

Mr. Schulze. In other words, the 10, 20 reduction would result.

Mr. Stark. Yes, personal rates would be down to about 44, and corporate rates maybe down only to 43; just keep it neutral. So it does not do that much in the rates.

The second part of your question, in terms of small business, it does not touch the $100,000 differential in the surtax. It would reduce it to $80,000. In other words, where we trim everything 20 percent for corporations, they would only get the lower rate on the first $80,000, rather than the first $100,000.

Mr. Schulze. How about things like the allowance, ITC on used equipment, and all those kinds of things which are really sort of oriented——

Mr. Stark. They would be reduced by 20 percent. For instance, if you had a small company, and it had a $10,000 investment tax credit, it only would get $8,000 of it. It only could use 80 percent, and it would lose the tax credit of $2,000. And therein comes the revenue.

Now, you can phase that out. You could say it is 80 percent of the tax credit the first year, and drop it down over 5 years.

Mr. Schulze. Would you consider a differential for small business and/or for those credits which are oriented toward small business? Most of the big conglomerates do not——

Mr. Stark. They would all be in there. The ones that are in there now would stay in, and they would be only 80 percent as valuable. That was the simplicity of it—everybody gets trimmed a little. I mean, the timber companies keep their credits, the small business companies keep their credits, the charities keep their deductibility. But only 80 or 90 percent of it. So everybody gives a little bit to help pay off the deficit.

Mr. Schulze. I thank the gentleman.

Thank you, Mr. Chairman.

Chairman Rostenkowski. Mr. Flippo will inquire.

Mr. **Flippo**. I have not read all of your testimony, but I wonder, do you have some specific revenue figures for each of the 5 years? Have you looked at that?

Mr. **Stark**. Yes, I do, Mr. Flippo, and I do not have them with me now, except to say it is more geometric than it is linear. It picks up most of the revenue, I think, in the fourth and fifth years. I think there might be a statement—it is attached to the statement about the second page from the end.

Mr. **Flippo**. Yes, I see it now. Thank you.

Mr. **Stark**. And as you will notice, the corporate revenues tend to build up toward the 1989-90 fiscal year.

Mr. **Flippo**. Thank you very much.

Chairman **Rostenkowski**. If there are no further questions, thank you, Mr. Stark.

Mr. **Stark**. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. The Chair calls Senator Bradley.

Senator, I know that you and our colleague, Mr. Gephardt, expect to testify jointly. However, we have been notified that Mr. Gephardt is on his way. So you may begin.

At the outset, I would like to welcome you and congratulate you on your pioneering effort in this area. Many of us are very familiar with your long effort to pass tax reform. I want you to know that we appreciate your taking time to share your views with us.

Senator Bradley, if you will begin, the committee is ready to receive your testimony.

STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM THE STATE OF NEW JERSEY

Senator **Bradley**. Thank you very much, Mr. Chairman.

I would ask the consent of the committee that my full testimony be placed in the record.

Chairman **Rostenkowski**. Without objection, your entire testimony will be inserted in the record.

However, I would like to point out to my colleagues that it is the intention of the Chair to work through lunch.

Senator **Bradley**. Mr. Chairman, I am very pleased to be here today as an advocate for tax fairness. At the outset, let me commend you and your committee for your foresight and initiative. I think together, we have an opportunity this year that is unprecedented, an opportunity for fundamental reform of our income tax system.

There are a number of things that have happened in the last year that make this a significant opportunity, not the least of which is the interest of the President of the United States in fundamental tax reform; the introduction of a number of bills from both sides of the aisle, by junior Members of the Senate and the House; and your own interest in tax reform and your committee's commitment to deliberate these issues thoroughly and to try to deliver a tax system that lowers rates and eliminates many of the unfair distortions that are in the tax expenditures. This is a very important series of initiatives.

Now, I believe that any tax reform legislation must meet three criteria. The first criterion is that a tax reform bill must not increase the deficit. The second is that it must retain progressivity, so that the tax burden on low- and middle-income people is not increased with tax reform. And the third criterion is that it must offer the lowest possible tax rate to the greatest number of people.

A tax reform bill that embodies these principles, I think, will clearly serve the general interest, giving the American people a fairer, simpler tax system with much lower tax rates.

Mr. Chairman, in a nutshell, that is what Congressman Gephardt and I have tried to do with our fair tax bill. The fair tax shows, I think—and it is not the only way to do so, but it nonetheless does—that tax reform can raise the same or even somewhat more revenues as the present tax system, but with much lower tax rates and far fewer loopholes. It can keep the same degree of progressivity as the present system, but ensure that people with equal incomes will pay equal tax. It can accomplish both of these objectives while preserving the most widely used, nonabusive deductions—things like mortgage interest, childcare, retirement income, and a few others. And in addition, it can help reduce the deficit by raising over $30 billion in the third year and by improving the overall efficiency of the economy.

So Mr. Chairman, the one bill that we have authored combines the following: Lower rates, which means more money and greater security for all people who work and earn; fewer brackets, which means relief from inflation, and a tax break for working couples; fewer loopholes, which means everybody gets a simpler, fairer system, with less cheating and more productive investment; bigger standard deductions and personal exemptions, which mean relief for young people, poor people, and the elderly, struggling to get by on fixed incomes.

It also retains certain key itemized deductions, which means a double benefit for middle-income taxpayers who have invested in their community and who deserve a measure of certainty in a time of change.

Let me say again, the fundamental proposition of the fair tax is fairness. It simply is not fair to burden tens of millions of taxpayers with needlessly high tax rates so that narrower special interests can enjoy their favorite loopholes.

Finally, the fair tax provides a 14-percent tax rate for four out of five taxpayers who now pay taxes. No tax rate would exceed 30 percent, which is a drop from the current top rate of 50 percent. Seventy percent of the taxpayers would pay the same or less tax; 30 percent would pay more. But in the long run—that is, years two, three, four, five, and on out—we believe everyone will be better off because lower rates mean that if you earn more, you are going to keep more.

This same principle applies to corporations. We drop the tax rate to a single 30-percent rate and broaden the tax base.

Mr. Chairman, tax reform is not just about money, because restoring fairness to the Tax Code, I think, would bolster people's sense of security, of being in control of their own lives, while at the same time, having a government that is sensitive to their needs. So, ultimately, tax reform is about dignity and hope; it is a call to the return of the values of our first leaders. And that is why, in my view, it cannot be dismissed without simultaneously diminishing our heritage.

I believe tax reform is the bridge between the past we are proud of, and the future we are unsure about. It is a choice about values, about what kind of country we want to be.

Mr. Chairman, I again would like to salute your courage in taking the lead on this tax reform issue, and I use the word with great awareness, because it is very clear that there is tremendous opposition to tax reform; it is going to get worse. The special interests, the firms and individuals who are using the loopholes to avoid paying their fair share now will try to intimidate people. They will try to threaten people, by telling them what they are going to lose without ever telling them that they are going to get lower tax rates in exchange.

In fact, I think if you look at the Washington Post every day since the Treasury proposal came out, and do a little catalog of those groups that started to complain about that particular proposal, I think that you would see that this is a new coalition in Washington. It does not have yet a K Street address, but it is the Coalition for High Marginal Tax Rates. Now, these groups' ideal world would have a tax rate of 70, 80, or 90 percent, with full deductibility for their particular thing, whatever that is—oil wells, office equipment, racehorses, avocados, shopping centers, whatever—that is the Coalition for High Marginal Tax Rates.

And no wonder this is the case. In 1967, the value of all tax expenditures was $37 billion. This year, the value of tax expenditures will be over $370 billion. It will take courage to resist the special pleaders. But I believe that there is broad popular support for lower rates and a fair income tax system. I believe it is the key to being able to embrace change, which I believe is the key to long-term growth and America's future.

We need a tax system that facilitates change, not impedes it; we need a tax system that rewards innovation, not opposes it; and we need a tax system that challenges the status quo, not one that enshrines the status quo.

We want a tax system that does not subsidize the politically powerful. We want a tax system that does not short-change our potential for economic growth.

Mr. Chairman, the next few months will be an exciting time. It will be a time of choice. Do we stand boldly on the side of fairness, of change, of growth, or do we stand on the sidelines, trading favors at the margin where "Them that has, gets."

Whatever we do, Mr. Chairman, we should know that the American people will be watching, because it is they who stand to gain or lose the most by what our committees do.

Again, let me salute you for your leadership and your courtesy in allowing me to come before the committee this morning.

[The prepared statement follows:]

Statement of Hon. Bill Bradley, a U.S. Senator From the State of New Jersey

Mr. Chairman, members of the committee, I am truly pleased to be here today as an advocate for tax fairness. At the outset, I want to commend you and your committee for your foresight and initiative. Together we have an unprecedented opportunity to achieve fundamental tax reform this year.

That these hearings are taking place under Chairman Rostenkowski's courageous leadership is proof of the progress that's already been made. They also presage future success. Indeed, I share President Reagan's optimism. I too believe that 1985 will be the year for much lower tax rates, far fewer loopholes, and a fair deal for every American who works, earns, and saves.

There will be plenty of naysayers and cynics who will dismiss what I have just said as wishful thinking. But there's good reason for optimism. Congressmen from both parties have endorsed specific tax reform bills. The Treasury has come forward with a detailed plan of its own. The President has already endorsed the basic principles of tax reform. And he has made a public commitment to lowering tax rates this year.

As I see it, this adds up to an impressive mandate. And the special interests know it. That's why they are spending hundreds of millions of dollars to deny Americans the fair, low rate tax system they need and deserve.

Naturally, I am proud that the Bradley-Gephardt Fair Tax, which Dick Gephardt and I unveiled in May of 1982, has attracted such as following. And while I'm sincerely flattered by all the imitations, this morning I want to tell you about the real thing. For I believe the Fair Tax best meets the three criteria that are essential for true tax reform.

What are these three criteria?

First, tax reform must not increase the deficit.

Second, it must retain progressivity so that the tax burden on low and middle income people is not increased.

Third, it must offer the lowest possible tax rates for the greatest number of people.

A tax reform bill that embodies these principles will clearly serve the general interest in giving Americans a fairer, simpler tax system with much lower rates and far fewer loopholes.

That, in a nutshell, is what the Fair Tax is all about—lower rates and fewer loopholes. Two years ago our bill set a new standard for tax policy. It showed that tax reform is not a code word for big government, "soaking the rich," or foreclosing on the middle-income homeowner.

Instead, the Fair Tax is a realistic, concrete plan to achieve a tax system that is significantly fairer and simpler than the crazy-quilt structure we all labor under today. The Fair Tax shows that tax reform can: Raise the same, or even somewhat more revenue as the present tax system, but with much lower rates and far fewer loopholes; keep the same degree of progressivity as the present system, but ensure that people with equal incomes pay about equal tax; accomplish both these goals while preserving the most widely used and non-abused deductions, like mortgage interest, child care, and retirement income; and help reduce the deficit by raising over $30 billion in its third year and by improving the efficiency of the economy.

This one bill combines: Lower rates, which means more money and greater security for all those who work and earn; fewer brackets, which means relief from inflation and a tax break for working couples; fewer loopholes, which means everybody gets a simpler, fairer system, with less cheating and more productive investment; bigger standard deductions and personal exemptions, which means relief for young people, poor people and the elderly struggling to get by on fixed income; and the key itemized deductions, which means a double benefit for middle class taxpayers who have invested in their community and who deserve a measure of certainty in a time of change.

Let me say it again. The fundamental proposition of the Fair Tax is indeed fairness. It simply isn't fair to burden tens of millions of taxpayers with needlessly high rates so that the narrow special interests can enjoy their favorite loopholes. That's the choice: lower rates versus loopholes. The people want the low rates while the special interests want the loopholes.

What the Fair Tax does is to close most of the loopholes and to use the revenue to pay for general rate cuts. Under Bradley-Gephardt, 4 out of 5 taxpayers would pay no more than 14% in tax. No one's tax would exceed 30%, compared with 50% under current law. The combination of cutting tax rates and eliminating loopholes leaves most taxpayers better off. In the first year of the Fair Tax, 70% of the taxpayers pay the same or less tax and 30% pay more. In the long run (years 2, 3, 4, 5, and so on), everyone will be better off because lower rates mean that as you earn more you keep more.

The same principle applies to corporations. The Bradley-Gephardt bill shows that the corporate tax can be reformed along the lines of the individual income tax, with a lower rate and fewer loopholes. By repealing many of the subsidies in the existing corporate tax, we eliminate economic distortions that stifle incentives and retard growth. In particular, by scaling back on the grossly inefficient ACRS depreciation system, we will be able to get rid of most of the most frequently abused tax shelters that squander scarce capital and enrich a few special interests.

But tax reform is not just about money. Restoring fairness to the tax code would bolster people's sense of security, of being in control over their own lives while at the same time having a government that is sensitive to their needs.

So tax reform is also about dignity and hope. It is a call to return to the values of our first leaders. That is why it can't be dismissed without simuitaneously diminishing our heritage. Tax reform—the Fair Tax—is a bridge between a past we're proud of and a future about which we are unsure. It's a decision about values and about the kind of country we want to be.

In my opening remarks, I referred to Chairman Rostenkowski's courage in taking the lead on tax reform. I used that word advisedly.

The reason is that there is already tremendous opposition to tax reform. And it will get worse. The special interests—the firms and the individuals who are using loopholes to avoid paying their fair share—will try and intimidate people, threatening them with what they'll lose without ever telling them that they'll get lower tax rates in exchange.

The special interests don't want lower rates. Because of the loopholes, they're paying zero now. And they want to keep it that way. You've all been visited by lobbyists for what I call "The Coalition for High Marginal Tax Rates." They represent special interests whose ideal is a world of 70, 80 or 90% tax rates with full deductibility of their "thing," be it oil wells, office equipment, races horses, avocados or shopping centers. The catch, of course, is that they use the loopholes to shelter their big incomes from taxes. But Mr. and Mrs. Average American are struck with the high rates and they pay through the nose.

No wonder the special interests like the tax system the way it is. They are the beneficiaries of the fastest growing government subsidy program in existence. In 1967, tax preferences were worth a mere $37 billion. Today they cost $400 billion. But as you all know, no one who argues to keep or expand a loophole ever admits it's a subsidy—they prefer to call it an "incentive." Subsidies or incentives, working Americans who pay for them have another name—"rip-offs."

It takes courage to resist the special pleaders by sticking up for the general interest. But that's what integrity is all about. It takes vision, too, a firm sense that embracing change is the key to America's future. We need a tax system that facilitates change and rewards innovation, not one that enshrines the status quo, subsidizes the politically powerful, and shortchanges our potential for economic growth. That's why the Fair Tax's fundamental proposition is that everyone, not just the privileged few, deserves a tax break and a better chance to prosper.

Mr. Chairman, the next few months will be an exciting time. It will be a time for choice. Do we stand boldly on the side of fairness, of change, of growth? Or do we stand on the sidelines, trading favors at the margin where "them that has gets?" Whatever we do, we should know that the American people will be watching, because it is they who stand to gain—or lose—the most.

Chairman ROSTENKOWSKI. Thank you, Senator.

Mr. Gephardt, you may proceed.

STATEMENT OF HON. RICHARD A. GEPHARDT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. GEPHARDT. Mr. Chairman and members of the committee, it is a great honor being here today to testify on our tax reform proposal.

I want to say, Mr. Chairman, that your leadership and that of the committee has been instrumental in moving this issue to the forefront of the American attention.

I think this is an issue that demands intense public scrutiny and debate and discussion, and I agree with you that legislation cannot be put together in some back room, but it must be developed in this committee, in the open, so that the American people and all the members of the committee and all the Members of Congress can be part of that debate in the putting together of this important legislation.

The reason that I am for tax reform is very simple. I have been on the committee for 8 years, and I have watched, I guess, about five major tax bills, and I have come to the conclusion that our tax laws do not work, and that in fact, our tax law when looked at as a whole is a national disgrace. It is painfully complicated, and I think it is painfully unfair. That is why many of us have been fighting for fundamental reform of our tax laws.

It has been 3 years since Senator Bradley and I first proposed our complete reform of the tax laws, called the Fair Tax Act.

We have three main goals, which Bill has outlined this morning. First, we want to make taxes simple and fair, and we want to foster economic growth.

Let us talk about fairness first. Right now, the Internal Revenue Service tells us hundreds of families earning over $200,000 per year legally pay no taxes at all. Some even make more than $1 million and legally pay no taxes. Hundreds of corporations also do not pay their fair share. Some even make a profit and still get a refund check from the Government at the end of the year. And this kind of unfairness erodes public trust, not just in the tax system, but in the Government itself.

I believe that everyone earning the same income in similar circumstances should pay more or less the same amount of tax. And we can get there by closing loopholes and shelters, the ones that are worth billions of dollars to corporations and privileged individuals.

I said we wanted to make taxes fair. We also want to make them simpler—simple enough so that Americans can figure theirs quickly and easily. If you are like me, you spent the last weekend, or the weekend before, or you will spend next weekend, at your kitchen table, trying to figure out your taxes. And you may have reached the same conclusion that I have reached—that the same three out of five 1040 filers reached—we gave up and hired somebody else to do it.

That is why we have 80,000 people in tax preparation in the United States—a force larger than the Naval Reserve and the Army National Guard combined. We have created a Jobs Program for tax lawyers and accountants.

Along with simplicity and fairness, we believe that tax reform gives us lower tax rates. In fact, the great majority of Americans would pay at a 14-percent rate under our bill.

I have listened to enough people to know that most of them want this kind of reform because of what it means to economic growth, and what it means to people's incentive to put their capital in investments that will actually make money, rather than just getting a tax break or getting their effective tax rate down.

I guess the question that we always ask is why haven't we been able to accomplish tax reform. And I think the reason is the one Bill touched on, and it is that here in Washington, we have to fight armies of lobbyists, who march the halls of Congress, representing interests that prefer the current law, with high rates and an eroded base and its carefully tailored loopholes.

I had a gentleman come to me and talk about the bill the other day in my office. He was with the real estate industry, and he was complaining about the provisions of our bill. And I asked if there was something wrong with the depreciation schedule, or something in the lack of an investment tax credit, or something that could be fixed to make the bill acceptable to him. He said no, the bill could never be acceptable to him because the tax rate was too low; he simply could not sell his real estate tax shelters with a 30-percent top rate.

Many people in other industries have said the same thing. So there is a real choice here, of whether we want low rates and a restored base, or whether we want high rates and an eroded tax base, which is what we have today.

I think that politically, we are talking here about transcending the usual system, the system that so many people know today how to manipulate. And we do it by choosing to take a stand with the growing ranks of people who really want and demand tax reform. And second, we do it behind tough political leadership—the kind of leadership that I think this committee has and has had in the past.

Our bill, the Bradley-Gephardt Fair Tax Act, has been on the table for 3 years. I think that it is time that we move forward with a deep consideration of this issue, and that we engage in the kind of work that I know we will on this committee—to really look at every part of these far-reaching proposals.

We cannot agree on all the details, but together, we can demonstrate to the American people the seriousness and the sincerity that we bring to this cause.

I think tax reform must transcend partisan politics, because it is an urgent national need.

I would end by simply again stating to the committee that undoubtedly, this is the most far-reaching tax reform debate that we have ever engaged in. I remember when I came on the committee in 1977, we had a tax reform proposal from the Carter administration, and frankly, most of it did not get enacted, as I remember. But I remember the difficulty of the debate.

It seems to me that what is being proposed here in all of these bills is much more far-reaching than that debate in 1977. I have no illusions about the difficulty of going through this, and I have no illusions about the political difficulty of getting a bill out of committee and then advocating and getting that bill passed on the floor of the House. But I do believe that there is a vast majority of Americans who really want this to happen. I believe that if we can do it, we will vastly improve our tax system and the credibility of our Government, and I look forward to working with the committee in the coming days to try to see if we cannot get a proposal together and vote it out of the committee onto the floor of the House.

I deeply the appreciate the opportunity to be here.

[The prepared statement and attachments follow:]

STATEMENT OF HON. RICHARD A. GEPHARDT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. Chairman, I want to thank you for holding these hearings today on what is one of the most important issues facing our nation. Your leadership, and that of this Committee, has been instrumental in moving this issue to the forefront of American attention. This is an issue that demands intense public scrutiny—legislation cannot be put together in some back room but must develop with the consensus of the people.

Let me get right to the point: Our tax laws are a national disgrace. They're painfully complicated . . . and they're painfully unfair. That's why some of us Democrats have been leading the fight for fundamental reform of our tax laws.

It's been three years now since Senator Bill Bradley and I first proposed our complete reform of the tax laws—the Bradley-Gephardt Fair Tax Act.

We have two main goals—we want to make them simple and fair . . . let's talk about fairness first.

Right now, the IRS tells us, hundreds of families earning over $200,000 a year legally pay no taxes at all. *Some even make more than a million dollars and legally pay no taxes.*

Hundreds of corporations also don't pay their fair share. Some even make a profit and still get a refund check from the Government. And this kind of unfairness erodes public trust not just in the tax system—but in Government itself.

I believe that everyone earning the same income, in similar circumstances should pay the same tax.

And we can get there by closing loopholes and shelters—the ones that are worth billions of dollars to corporations and privileged individuals.

I said we wanted to make taxes fair. We also want to make them simple . . . Simple enough so Americans can figure theirs quickly and easily.

If you're like me, you may have spent last weekend at your kitchen table trying to figure out your taxes. And you may have reached the same conclusion that I reached . . . the same one three out of five 1040 filers reached . . . we gave up and hired someone to do it.

That's why we now have 80,000 people in tax preparation in the United States. A force larger than the Naval Reserve and Army National Guard combined. We've created a jobs program for tax lawyers and accountants.

Along with simplicity and fairness, the Bradley-Gephardt bill gives us all lower tax rates. In fact, the great majority of Americans would pay a low 14 percent rate.

I've traveled enough miles and listened to enough folks to know that most of them want this kind of reform.

So why haven't we done it? Because here in Washington we have to fight armies of lobbyists who march the Halls of Congress representing selfish interests that prefer the current law and its carefully-tailored loopholes.

How do we fight them? How do we win the battle for tax reform?

We do it by transcending the usual system. The system these people know how to manipulate. We do it by choosing to stand with the growing ranks of Americans who demand tax reform.

Second, we do [illegible] behind tough political leadership . . . and in my view that leadership has got to be bipartisan.

Our bill—the Bradley-Gephardt Fair Tax Act—has been on the table for three years. We're still waiting to see the administration's bill.

But when we have one I think it's time we all set our partisan interests aside for a season and put our shoulders to the wheel.

We won't agree on the details, of course. But together we could demonstrate to the American people the seriousness and sincerity we bring to this cause.

Tax reform should transcend partisan politics—because it is an urgent national need.

To that end, I would like to mention a few highlights of the Bradley-Gephardt Fair Tax Act:

It would support the majority of the American public and an increasing percentage of the corporate community in their common call for reform and simplification of our tax code.

It would substantially reduce tax rates. Four out of five Americans would pay taxes at the lowest rate under our bill—14%. The top individual rate would be 30% . . . down from the current 50% . . . That's a 40% reduction in the top rate!

It would reduce the corporate tax rate from 46% to 30%.

It would substantially broaden the tax base by eliminating most deductions and credits.

The bill would retain the most universally used and accepted deductions: home mortgage; charitable contributions; state and local income and real property tax; medical expenses in excess of 10% of AGI, and IRA and Keogh contributions.

It would bring in as much revenue as the current system.

It would retain the progressive concept from the current code and the current distribution of tax burden between income groups.

And the bill would replace the costly, overgenerous ACRS depreciation system with one that reflects an asset's useful life.

The cause of tax reform is an unparalleled challenge for this committee. But it is also a kind of calling . . . an opportunity to address what may well be the pivotal issue of our day.

People sense that the law we're living with is unfair. People perceive their neighbors cheating at their expense—and they are often right. They resent the extra cost of an expert to guide them through the maze. And this creates compliance problems both seen and unseen.

Surveys find more and more believing it's okay to cheat because they think everyone else is doing it—and getting away with it. We all pay a heavy price for this breakdown of trust and integrity. I believe that such a wound festers . . . and it spreads the infection of distrust throughout the body politic.

This not only makes it harder for government to raise the revenues its responsibilities require, it makes it harder to accomplish anything at all. Today's tax code is eroding public trust. It is a breach of the social contract that organizes our national life.

All this gets aggravated by an Administration that constantly tells the people government is their enemy. An Administration that confuses tax reform with tax hikes or dress up the latter as "revenue enhancement."

These are really political reasons for examining our tax system. Economics provides us with separate and equally compelling reasons.

My complaint here is that we've attempted to direct the economy by manipulating the tax code and that the attempt has failed dismally. Worse yet, it has been counterproductive.

Again and again, the tax committees of Congress are asked to wield the tax law as a kind of economic shotgun. We're asked to pick winners and losers. All too often, we wind up giving too much away to unproductive and inefficient areas of investment.

Nearly a quarter of all the bills in the House are now referred to the Ways and Means Committee. Clearly, we are past the point of enacting rational tax policy. We are becoming a mini-House, a substitute for program legislation. As the budget deficit closes down everything else, it leaves the tax code the last game in town. If you have an idea, a proposal or a cause, you do what you can for it in the code.

In fiscal year 1985, the federal government will have more than $365 billion in tax expenditures. This is up from $228 billion in 1981 a $137 billion increase since the beginning of the Reagan Administration. The value of tax expenditures far outdistances the budget for the department of defense.

But however well-intentioned, these tax expenditures are not yielding economic solutions. Instead, they're causing new economic problems.

Partisans in politics and economics continue to debate how much the 1981 tax cuts and other tax bills have encouraged people to save. But we have proved that we can channel investment. The question is whether we can do so wisely.

I'm not talking about high finance and leveraged buyouts here. One look around the barnyard gives you a good picture of what our tax laws are creating. Looking at Money magazine recently, I was struck by an ad for super-dairycow tax sheltered investments. Investments in such shelters continue even as we pile up tons of dairy products to rot in federal warehouses. This continues while taxpayers prop up the price of these products. Something is clearly wrong.

I would argue that our current tax system is, at best, an irrelevant distraction from what is really happening in American society and—at worst—actually counterproductive at worst. Even the tax provisions that may move us in a positive direction achieve less than they might because every year we come back to ransack the code searching for revenue.

So today's tax break could almost become a target in tomorrow's revenue enhancement. At a minimum, this reinforces the disturbing emphasis on short-term gains at the expense of longer commitments. But further, it forces not only tax practitioners but individual taxpayers to keep abreast of each change—a considerable bother and expense.

Repeated changes in the code also place a significant burden on the Internal Revenue Service. Ask IRS Commissioner Roscoe L. Egger, Jr., who has said . . . and I quote: "As an agency, we are tied up in knots . . . drafting regulations to explain the frequent changes in law."

Perhaps the worst thing is that the ever-changing code prevents individuals and businesses from planning. They can't rely on the code to be constant from one year to the next. In the first Reagan term, this committee produced three major tax bills—not to mention the Social Security bailout package and all the lesser legislation.

What did we accomplish with these bills? Well, we lengthened the already lengthy code and deepened its dense thicket of cross-references. Was our goal to minimize uncertainty and complexity? Then we failed. In fact, we made matters worse.

Tinkering is not going to turn the trick. It's time to get radical.

The Fair Tax plan would largely disconnect the question of revenue collection from all the other questions of economic policy. It is an acknowledgement by two members of the tax-writing committees that our efforts to focus investment just haven't worked.

The Fair Tax plan for families includes tax rates of 14%, 26% and 30%. There's no preferential capital gains rate. Some of the most popular deductions, including charitable donations and home mortgage interest are retained—but they generally apply only against the 14% basic rate.

The means that each dollar spent on such activity results in a 14 cent tax reduction—regardless of one's income. We won't be giving 50 cents on the dollar for mortgage interest on a mansion anymore.

I might mention parenthetically here that we set out to remove as many tax deductions as possible. Those that survive reflect our political judgments about making the Fair Tax palatable. We're more interested in a winning package than we are in philosophical purity.

On the corporate side, the Fair Tax couples a flat 30% tax with depreciation rates derived from real life. For estates, for example, we'd take the depreciation period back to 30 years—which is where it was before the 1981 tax act.

We want to let business take care of business without being overly conscious of tax consequences. We want to get as much revenue from corporations as current law does; but we'd moderate the current disparity between most-favored and least-favored industries.

Let's talk about what the Fair Tax Act doesn't do.

It is not a tax increase. It is not designed to raise more money than the current system. It doesn't redistribute the tax burden among various income classes—nor does it disturb the existing ratio between business and personal taxation.

Nevertheless, it will provide a tax cut for most taxpayers (approximately 70%). There's no sleight of hand here. The savings come at the expense of those who are now the most sophisticated manipulators of the code. If you've been altering your behavior substantially for no reason other than tax avoidance, this probably means you.

Where do we begin in making so fundamental a change in approach? I think we begin by agreeing that fundamental change is needed. We begin by agreeing that the current system—even with all its investment incentives and other special features—is part of the problem when it comes to creating a healthier American economy.

COMPARISON OF PRESENT LAW AND THE FAIR TAX ACT

	Current law	Bradley-Gephardt
INDIVIDUAL INCOME TAX		
Tax rates:		
Ordinary income	11–50 percent	14 percent, 26 percent, 30 percent
Capital gains	20 percent maximum rate	30 percent maximum rate
Alternative minimum tax	20 percent	Repealed
Exemptions:		
Taxpayer	$1,000	$1,600
Spouse	$1,000	$1,600
Dependent	$1,000	$1,000
Blind, aged	$1,000	$1,000
Zero bracket amount (single, joint)	$2,300/$3,400	$3,000/$6,000
Indexing	Yes	No
Incoming averaging	do	Do
Taxable Income:		
Dividends	$100 excluded	Included
Municipal bond interest	Excluded	Interest on public-purpose bonds excluded
IRA, Keogh earnings and earnings on pension reserves	do	Excluded
Employer contributions for health insurance plans	do	Included

COMPARISON OF PRESENT LAW AND THE FAIR TAX ACT—Continued

	Current law	Bradley-Gephardt
Employer contributions for life insurance plans	do	Do
Social Security benefits (single/joint)	Half benefits taxed if modified AGI over $25,000/$32,000[2]	Current law
Unemployment compensation	Included, depending on other income[3]	Included
Employment income	Included	Do
IRA, Keogh contributions	Deducted	Current law
State and local taxes:		
Income	do	Deducted at 14 percent rate
Property:		
Real	do	Do
Personal	do	Not deducted
Sales	do	Do
Charitable contributions	do	Deducted at 14 percent
Medical expenses	Only if more than 5 percent of AGI	Only if more than 10 percent of AGI
Home mortgage interest	Deducted	Deducted at 14 percent rate[4]
Other nonbusiness interest	do	Nonbusiness interest limited to amount offset by net investment income, deductible at 14 percent rate[4]
Two-earner deduction	10 percent of earning of lesser earning spouse, up to $3,000	Not deducted
Capital gains	60 percent excluded	Included
Capital losses	50 percent taken against income, up to $3,000	Limited[5]
Loss carryover	Unlimited	One year
Corporate pensions	Deferred tax	Limited[6]
Tax Credits:		
Earned income credit	Yes	Yes
PROVISIONS AFFECTING BUSINESS		
Investment tax credit	6 to 10 percent	No
Intangible drilling cost of oil, gas and geothermal	Expensed	Assigned to 10-year depreciation class
Treatment of depletion oil, gas and geothermal	Cost depletion for integrated oil companies, percentage depletion for mineral producers and independent oil companies	Do
R&D credit	Yes	No
Targeted jobs tax credit	do	Do
Rehabilitation credit	do	Do
Excess bad debt credit	do	Do
Employee stock ownership plan	do	Do
Depreciation	Accelerated cost recovery system	"Open Accounts" based on modified ADR asset lives
CORPORATE INCOME TAX		
Tax Rates:		
Regular	15 to 40 percent on first $100,000, 46 percent thereafter	30 percent
Captial gains	28 percent	Do
Add-on minimum tax	15 percent	Repealed
Deductions:		
Capital losses	Limited to capital gains	Current law
Excess capital losses	Carryback 3 years, carryforward 5 years	Do
Charitable contributions	Deducted	50 percent deduction

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[1] 14 percent—on individual income up to $25,000, joint income up to $40,000. 26 percent—on individual income between $25,000 and $37,000, joint income between $40,000 and $65,000. 30 percent—on individual income exceeding $37,500, joint income in excess of $65,000.

[2] Modified adjusted gross income (AGI) includes AGI plus one-half of the Social Security benefits plus interest on tax-exempt bonds.

[3] If AGI plus unemployment compensation exceeds $12,000 for a single return ($18,000 joint return), half of the excess is included in income up to the amount of the benefits.

[4] Also deductible up to the limit of net investment income from AGI for taxpayers who pay the surtax.

[5] Limited to capital gains plus the smallest of: taxable income, or $1,500 ($3,000 joint), or net capital loss. For this purpose, taxable income excludes capital gains, capital losses, and personal exemptions.

[6] Defined benefit plan limit reduced from present $90,000 to $60,000. Defined contribution plan limit reduced from present $30,000 to $20,000.

Chairman **Rostenkowski**. I thank you both.

Gentlemen, does your bill take the position that individuals and families below the poverty level should not be subject to tax?

Senator **Bradley**. What we do is increase the zero bracket amount and the personal exemptions, so that a family with two children would not receive their first dollar of taxable income until they had exceeded $11,200 in income. So we believe that low-income families are best protected by raising the floor before they get a dollar of taxable income.

Chairman **Rostenkowski**. Some critics of the Treasury proposal have argued that the reduction in capital cost recovery benefits would force manufacturing facilities to move offshore.

Do you consider this a significant problem? Have you considered whether your proposal deals with this difficulty?

Mr. **Gephardt**. Well, we did an awful lot of work in trying to put together our depreciation proposal. We feel that it is obviously not as generous as present law, but we think it is a reasonable way to try to produce actual economic depreciation; in other words, to have the depreciation scheme in the code really track actual economic depreciation.

We also set up a system where you put different assets in different categories or pots, and you depreciate each category, rather than trying to depreciate each particular asset, which we think is a real blow for simplicity, especially for small businesspeople, who have a lot of trouble keeping track of all their different assets.

The Treasury proposal, as I understand it, is even less generous than our proposal, by a good deal, I am told, in terms of the amount of money it would pick up compared with what our proposal picks up over present law.

I think the amount of money that we pick up over present law is a reasonable amount to pick up, if you are really trying to move to a system that actually reflects actual economic depreciation. I think to go further than that really causes the kinds of prejudicing of investment decisions that are unwise in the Tax Code, and I do not think that moving to this kind of a system cripples industries that are capital-intensive.

My sense in the last couple of years is that with all the depreciation relief we gave in the 1981 bill, there has not been a lot of money invested, for instance, in the steel industry, which was one of the targets of 1053.

So I think this kind of a system really does make more sense.

Senator **Bradley**. If I could intervene here, Mr. Chairman, I think that the effect of the bill overall would be to improve our competitiveness internationally, because it would lead to a more efficient allocation of capital. As it is now, the Tax Code clearly skews investment and rates of return so that industries that are heavily dependent on inventories pay a higher tax rate, a much higher tax rate, than industries that are capital-intensive, and industries that are highly dependent on labor—and that is not simply manual labor, but brain power, as well—end up paying a much higher tax rate.

What we want to do is to allow the market to allocate that capital among all of those potential uses, and as it does it efficiently, our comparative advantage internationally will be enhanced, just as wealth and jobs will be created.

Chairman ROSTENKOWSKI. Let me share just one thought with you two pioneers of the tax reform effort.

In question-and-answer periods, I have been exposed to various sectors of society. I agree with you that the "carrot" in this effort is the marginal rate reductions. I do not know whether this committee will set a rate reduction target at a point that we feel will satisfactorily attract the American people to support the legislation.

But I found in my discussions that rate reduction is attractive. However, there is an element of unfairness that even transcends the rate issue. When corporations with profits of $2 or $3 billion do not pay tax, then the revolution starts. That is when my constituents say: "I do not mind paying taxes, but I think it is unfair when other people and corporations do not pay taxes."

I think that in the long haul—and I am very optimistic about enacting legislation this Congress—I think in the long haul, that will be the "carrot" even more than the rates. Certainly, we will need to reduce rates. However, the essential idea is that we want our tax system to be fair—that when people enjoy a large profit, by gosh, they should pay taxes on it.

If we can reach that goal in this Congress, I think that I will certainly be happy.

Mr. Duncan will inquire.

Mr. DUNCAN. Thank you, Mr. Chairman.

I want to welcome our colleagues. They are certainly to be commended, both Senator Bradley and Mr. Gephardt, in examining, I think, the important tax reform issues and bringing your own proposal here.

The enactment, though, of any dramatic tax reform proposal necessarily brings with it, I guess you might say, a certain amount of risk, and in particular a disruption in economic viability of our industry in this country. Do you think that your improvement in the tax system that would be achieved would really disrupt the economic growth of this country?

Mr. GEPHARDT. Well, John, there are studies on both sides of the issue. I have seen economic studies that say that tax reform will enhance economic performance in terms of the leading indicators. There are other studies that say the opposite. It really depends, I guess, on where you start and the kinds of assumptions you put into the computer.

I do not think we are ever going to have a completely satisfactory answer to the question of will this really engender greater economic performance.

My own belief is the one that Senator Bradley shared, and that is that with lower rates and less capital allocation incentives in the code, the economy overall, in the long run, will work better if people are making decisions based on economics rather than tax consequences.

I think the second part of your question is how do we get from here to there. If you assume you want tax reform, how do we get the country and all the taxpayers from where we are with present law to the new law; what kind of a transition do we plot out to get the code moved in that direction.

Obviously, in every tax bill we have done, we have always had to write transition rules. This would be the "granddaddy" of all transition rules, because of all the parts of the code that would be affected, and it would be a difficult transition rule to write.

I think most of us would want a liberal transition rule, but obviously, there is a cost to that, because you would be leaving people where they were, and if you have lowered the rates immediately, there obviously would be a cost to that, and it is something we have to consider.

Some have suggested that the transition be one that phases in the rate cuts as you phase out the application of present law with regard to the base. Some economists will tell you that they do not like that at all, that you have got to bring the rate cuts in immediately, and that that kind of a transition would be very cumbersome.

I think these are all things, however, that we are going to have to look at, because I agree with you that this is a big transition, and one that you want to think through very carefully, so that you do not have the kind of disruption in the economy that people fear.

Mr. DUNCAN. How long a transition rule do you suggest?

Mr. GEPHARDT. We do not have one in our bill, and I do not know that I have a clear-cut suggestion for you today. Some people would say that you grandfather every existing transaction. That would obviously be the most liberal thing you could do. It would be quite expensive.

Mr. DUNCAN. Do you agree that there are really a lot of unanswered questions in all these proposals that we should examine in this committee?

Mr. GEPHARDT. I think there is no question that they all must be examined. I think the transition rule is one on which a good deal of work has to be done, but I am convinced at the same time that it is possible to have an orderly transition from present law to this kind of a bill, and I think that going through that is going to be necessary to get these important changes made in the code.

Mr. DUNCAN. Could either one of you contrast the incentives for capital formation in your proposal as compared to the Treasury reform proposal and the other tax proposals?

Senator BRADLEY. Mr. Duncan, let me start with what I believe our proposition is, and that is that the best tax incentive for capital formation, the best tax incentive for investment and savings and work, is the lowest possible tax rate on profit. That is what we believe. That is one of the premises of the bill, and that is why we want the top tax rate dropped as low as possible.

The way that we have tried to stimulate capital formation has been to provide varying tax rates for different investment vehicles. And we believe that the thing that will drive it is the lowest possible tax rate on profit, generally. We have eliminated a lot of the special savings vehicles in order to get that top rate down.

But to go back to your previous question—will it disrupt the economy—well, it depends on to whom you ask that question. If you ask that question of somebody who does not pay any taxes, and they are going to have to pay some taxes, they will argue it is a big disruption for the economy. But if you talk to someone who now pays an effective tax rate on the corporate side of 43 percent now, and they are going to end up with a 30-percent rate, they will say there is no disruption at all. And this is where I think the rule of reason has to come in. This is clearly an area where the committee has an enormous amount of work to do, both this committee and in the Senate. And I believe that as long as we agree on the direction of lower rates and a simpler system with fewer loopholes that is fairer, as the chairman said, I think that those transition rules are clearly going to be a battleground. But I think that they will be driven by the overwhelming support for moving in this direction.

Mr. DUNCAN. My time is up.

Thank you, Mr. Chairman, and I thank you both.

Chairman ROSTENKOWSKI. Mr. Stark will inquire.

Mr. STARK. Mr. Chairman, I just want to thank both of the gentlemen testifying today for real leadership in this area of reform. I am jealous. I wish that the Stark-Chafee bill accomplished anywhere near what you are doing. And I look forward to working with both of you over the months ahead.

I guess the only thing I am concerned about is leaving vestigial loopholes in the code that just invite us to go through however many years it has been since we have had the investment tax credit, which was supposed to be there for 2 years, as I recall; as long as we leave deductibility of interest in; as long as we leave the real estate industry able to go below zero; as long as we leave any little pieces of—and I am not picking on them in particular—don't we just invite, after going through all the work, assuming we could go through the work and get such a monumental task finished, don't we then just ask for us to go through this drill for the next 15 years, of increasing the size of those loopholes and not having enough fingers to put in all the holes in the dike?

Are you convinced that we have closed down tight enough on the ones that you do not want to see grow?

Mr. GEPHARDT. My answer would be that I think that if we can get as much of the base restored as we call for in our bill, or in some of the other bills, that will be a real feat for us to perform. And it is certainly worth doing, even if the price is to leave, as you say, some vestiges of preferences in, that you may question.

And people often say to me, "Well, won't you just go back and put them all back in again?"

And my answer is that of course, you cannot guarantee that that will not happen. But my analogy is alcoholism. You get to the point where you are really in trouble, and then you have to dry out, and then maybe you do start over again, but at least it was good to have the process of drying out and starting over again. And that really is where I think we are.

As you know, we used to do bills that were very small, and now we do 1,300-page bills on almost an annual basis, trying to further refine and describe the kinds of preferences that we put in the code through the years. And if we do not go back—and really, in an oversight process, which is kind of what this is—take a lot of things out that perhaps have outlived their usefulness and go back to a simpler situation, I think we are going to be in real trouble in years to come.

Mr. STARK. Everything that you leave in, in effect, in its simplest form—let's take homeowner's mortgage interest—wouldn't it be a better strategy for us to have those things sunset at some point, or get a review, so that the pressure by the vested interests would be on us to have a bill, rather than—if there is automatic expiration, you get a chance to review the effectiveness of a credit or a deduction, to see whether we are getting the jobs or the capital investment or the charitable contributions that we expect, and then, if we do not, we can just quietly let it expire, as opposed to just having it go on forever.

Senator BRADLEY. My reaction to that would be that ultimately, this is a political judgment. I think that if we were able to broaden the base as much as we envision under the Fair Tax, I would not want the whole thing to fall down on whether there is sunsetting for mortgage interest. I mean, it is a kind of balance that you have to strike here.

So, I believe that the key is to put the real effort in getting a bill done this year. I draw an analogy to my experience after joining the Senate Energy Committee. I had been there about 6 months when I realized that there were now three sacred documents in U.S. Government history: The Declaration of Independence, the Constitution, and the Natural Gas Policy Act of 1978.

And my sense is if we ever get fundamental tax reform done, I do not think we are going to see people wanting to go back and touch it for a while, and that might be just the breathing spell that so many of my constituents ask me for every year, as they have to deal with yet another tax bill.

Mr. STARK. Thank you.

Chairman ROSTENKOWSKI. Mr. Flippo will inquire.

Mr. FLIPPO. I have no questions, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Gregg will inquire.

Mr. GREGG. Thank you, Mr. Chairman.

I was wondering if you had any figures on what percentage of the corporations which are now paying, in amounts paid, would find their tax rates going up as a result of your bill?

Senator BRADLEY. We don't have a percent exactly. The number that I can give you that I think illustrates where we were coming from is that under our bill, corporations as a group contribute the same amount of revenue as they do under current law. Under the Treasury proposal, corporations contribute a larger amount of total revenue, at least in the early years.

Clearly, industries that are inventory-intensive, that are labor-intensive, or R&D-intensive are going to pay less taxes. Corporations that are now not paying taxes are going to pay more.

Mr. GREGG. If I could stop you there, you are saying, then, that there is essentially no economic shift between individuals and corporations as to the burden of the tax laws?

If that is true, then, what you are basically saying is that you want to restructure our industrial base around the private sector versus the tax laws.

Senator BRADLEY. I am sorry, I do not——

Mr. GREGG. Is the basic philosophy here to get to a marketplace driving the dollar investment as versus the tax laws driving the dollar investment?

Senator **Bradley**. That is right.

Mr. **Gregg**. If that is true, why did you keep so many of the deductions in the code at all.

Senator **Bradley**. Well, I guess it is something I call critical political mass. I agree with you, if you were going to do the perfect academic tax reform proposal, it would not be Bradley-Gephardt.

Mr. **Gregg**. But we are going to expend a phenomenal amount of blood over your proposal—which I think is a very attractive proposal in many ways—and it just seems to me that if we are going to expend this blood, and we are only going to go through it once—and I happen to agree with you that when we get there, we are probably going to have the fourth sacred piece of legislation—why not go all the way?

You have got at least 13 or 14 major items of personal deduction kept in the code. I would hate to think of the number of deductions in there that are going to be kept in in the area of corporate mergers and acquisitions and takeovers that are going to be necessary. Why not say, listen, we are going to go for everything—why play games with this?

Mr. **Gephardt**. Well, that certainly is a position that you can take and that may be asserted in the committee's deliberations. Many have asserted it for a completely flat tax. And there are proposals before the Congress to take all the deductions and preferences out and go to one rate.

Even if we were to do that, I would still want a progressive rate system, so the burden is more or less the way it is today between income groups. But that certainly is a position to take.

We came to the conclusion in looking at that and in looking at other proposals that, as Bill said, you had to have a critical political mass, and that if we took out things like the home mortgage interest deduction or the charitable contribution deduction, we simply could not move the proposal through the Congress.

The ones we kept we think are the most universally used and accepted deductions, and the ones that you politically must keep in order to have a feasible chance of moving it through the Congress.

But from a theoretical point of view, what you assert is certainly credible and something that should be asserted in these deliberations.

Mr. **Gregg**. Well, the first witness, Congressman Stark, said everything was on the table, and I think the chairman said everything was on the table. Under your bill, everything is not on the table. There is a vast amount of items that are not on the table. And I have no problem with eliminating this all and going to progressivity; I do not think a flat tax makes much sense, because I do not think it is fair.

But if you eliminated them all and went to progressivity, why not?

Mr. **Gephardt**. Well, let me make one——

Mr. **Gregg**. I mean, think of all the toes you have stepped on just by knocking out what you have knocked out. Why not step on a few more?

Mr. **Gephardt**. Well, obviously, everything is on the table. When the committee meets, it is going to look at all the bills that are out there, including flat tax bills, and ideas that are not even in the form of bills. So obviously, the committee is going to consider everything, and I have no problem with that.

I would say to you that on the corporate side, I find it impossible that we would write a tax law that would not have the allowance of business expenses or that would not have the allowance of depreciation. I simply do not see how, from an economic viewpoint, much less a political view point, we would want to do that.

Mr. GREGG. Well, of course, business expenses are a given, because we are talking profit here, and business expenses would have to be considered.

If you could just go over for me, Senator—you said you eliminated certain expenses for savings—maybe I misunderstood you—in order to get to your rate. Can you talk about what those incentives were?

Senator BRADLEY. Sure. We eliminate the tax-exemption for interest on industrial development bonds, for example, and the $100 dividend exclusion. We treat all income pretty much the same. Therefore, we eliminate the distinction between ordinary income and capital gains and the capital gains rate goes from 20 to 30 percent. And, with all of the revenue, not just from these provisions but from all of the other provisions that we eliminate, we are able to drop the tax rate to a top rate of 30 percent which, if you are interested in capital formation or investment, means the top rate on interest income drops from 50 to 30; it means the top rate on dividend income drops from 50 to 30; it means there is no distinction between short- and long-term capital gains. It means also that, with the revenue on the corporate side, you are able to have a 30 percent corporate tax rate. A 30-percent corporate tax rate should be a major benefit to venture capital firms that, as they start up and are not heavily capital-intensive, end up with a much higher effective tax rate than 30 percent. That should be reflected in share price, and we believe in the long run that lowering the top rate to 30 percent is enough to compensate for giving up some of those provisions.

And you know, I come at this thing as someone who, back in 1981, proposed dropping the capital gains rate even lower to 15 percent.

If I could just go back to your question about why do we keep any of these credits, exclusions and deductions, I think we keep them because we believe we can have the best of both worlds. We believe we can have a simple, low-rate tax system and preserve the nonabusive credits, exclusions, and deductions that are most used by middle-income people.

So the decision to put some of these in the code was not simply a political judgment, although that was clearly an important part of it, but it was also a way that we kept the present progressivity of the system intact.

Mr. GREGG. Thank you.

Chairman ROSTENKOWSKI. Mr. Coyne will inquire.

Mr. COYNE. Thank you, Mr. Chairman.

I want to thank you both for your excellent testimony and for a basically sound proposal. I know that it will receive a lot of examination in the coming months.

I have one question: how does your proposal address the State and local tax deduction?

Mr. **Gephardt**. We continue to allow the deductibility of State and local income tax and real property tax. We do not continue to allow the deductibility of sales tax or the personal property tax.

However, the deduction for income tax and real property tax is limited to the first bracket, so that it is worth 14 cents on the dollar.

Now, four out of five Americans under our plan would pay at the 14-percent rate; so they would in most cases get the full measure of their deduction. But people who have higher income would not get the full import of the deduction as they get it today.

Mr. **Coyne**. Thank you very much.

Senator **Bradley**. I might add, even though many of them could end up paying a lower tax rate, because the rate dropped from 50 to 30 percent.

Chairman **Rostenkowski**. Mr. Pease will inquire.

Mr. **Pease**. Thank you, Mr. Chairman.

I, too, would like to commend both Senator Bradley and Congressman Gephardt. I am a cosponsor of your legislation and I think that your bill, our bill, is an excellent tax reform proposal.

I am particularly interested in economic growth. One, what effect do you think that the proposal, if enacted, would have on U.S. corporations that do business overseas? As you know, there is presently a deferral of tax on earnings of U.S.-owned foreign corporations. How does this proposal deal with that question?

Senator **Bradley**. Well, as I said earlier, I think that it will improve the overall competitiveness of the U.S. economy. We allow a continuation of the foreign tax credit with the overall limitation.

The Treasury proposal does not. It puts a per-country limit on the foreign tax credit. We keep the credit, but we keep an overall limitation. We believe that that is desirable, and at least I believe that to move to change it as the Treasury has done could largely be viewed as unworkable.

Mr. **Pease**. As you know, I have been a sponsor for the last couple of years of a study of the effective tax rates of U.S. corporations. A lot of corporate sectors are paying effective tax rates of 1 percent, minus 2 percent, 3 percent, and so on. Clearly, they will have to pay more under your proposal.

One of these areas of concern is the steel industry with respect to its ability to come back and to make the capital investments necessary to become modern and compete with the Japanese and the Koreans and so on.

Clearly, this proposal, for all of its benefits in terms of economic purity, will mean a substantially lower cash flow for the U.S. steel industry, and presumably, a direction of resources into other economic areas.

Is it acceptable for our society to effectively write off the steel industry?

Senator **Bradley**. Obviously, I do not think it is an acceptable policy for our economy. I wonder, really, how much in taxes some of the steel companies pay. I think that many of them currently have no tax liability and won't have to pay taxes for the foreseeable future. And I think sooner or later that the industry will adjust to a competitive international marketplace.

If it is the decision of Congress to subsidize a particular industry because it is critical, then I think the key thing is to identify the overriding public purpose that would be served by subsidizing that industry, target the subsidies narrowly, and limit the amount of the subsidy to no more than we think is needed to achieve the result.

I do not believe that our proposal, however, means anything close to the end of the steel industry in this country; to the contrary.

Mr. Pease. Let me turn now to your proposal to repeal the alternative minimum tax for individuals. I think you mentioned in your testimony that there are a number of people who earn $100,000 or more per year who pay no taxes at all.

Your proposal would allow interest to be tax free on public purpose bonds. Presumably, then, if a person invested $1 million in tax-free bonds, he could still make $100,000 in income and pay no taxes.

Is there any problem with that?

Senator Bradley. Well, my answer to that is that we made a decision that there was a constitutional question about taxing the interest on general obligation bonds and decided not to do it. Now, you give up certain equity considerations when you do that, but we recognized what we thought was a constitutional principle there that was overriding.

Mr. Pease. Couldn't you accept the constitutional principle and still get at that income by including the minimum tax for individuals, retaining that rather than repealing it?

Senator Bradley. Well, if you look at our bill, we have a basic tax of 14 percent and then two levels of surtax. The surtax is essentially a minimum tax, and that is the way that it can, and I think, and I hope, as the debate progresses, it will be viewed, because many of the credits and exclusions and deductions will be part of the determination of income at the surtax level.

Mr. Gephardt. That was our basic view. We felt that we had achieved a minimum tax in the way the whole bill worked. Your point is well taken, though, and perhaps does dictate another look, because we would not want to have a case where, through the use of municipal bonds, someone could escape taxation. So I think it is worth a second look. I appreciate the point.

Mr. Pease. Thank you very much.

Chairman Rostenkowski. Mr. Schulze will inquire.

Mr. Schulze. Thank you, Mr. Chairman.

I, too, would like to thank the gentlemen for their testimony.

Have you looked at the impact of your proposal on regions or areas of the country?

Mr. Gephardt. I am not aware of a study that does that. There are a number of economic studies that have been done at different universities and different econometric models. Some say that it would help the economy; others say that it would not.

There is probably one that I remember that says it would have a negative impact on capital investment in basic industries. We argue against that and feel that the facts are otherwise.

But I am not aware of a regional study.

Mr. SCHULZE. It seems to me that a study of your legislation—it holds the potential for having a negative impact on the older industrialized States such as Pennsylvania, Ohio, Michigan, and so on. And I realize that high-tech is the wave of the future, and it is very glamorous at the moment. But I think we have got to be very careful before we have a large negative impact on the older industrialized States. So that is why I asked the question, because I would have to guess, looking at your legislation, that it would have a negative impact on, as you said, the older basic industries.

If that is proven to be so, do you think it should be adjusted or changed?

Mr. GEPHARDT. Let me argue with the basic proposition that this would hurt older basic industries. The thing you have got to keep in mind is that the rate for corporations goes from 46 down to 30 percent under our bill, and another bill that is different, but you get that basic rate down.

That means any corporation that can turn a profit is going to do better under this bill than they will under present law, in most cases even taking into account the ITC and the depreciation that exists under present law.

I think the real proof of what we are asserting is in the fact that we put in 1,053 in the hopes that steel and machine tools and some of the older industries would plow a lot of money back into their industries and become competitive in rolled steel with the Japanese and so on.

Mr. SCHULZE. And as you know, they did plow that money back in.

Mr. GEPHARDT. They plowed some money back in.

Mr. SCHULZE. All the profits from the steel industry were plowed back into the business in capital acquisition.

Mr. GEPHARDT. I understand.

Mr. SCHULZE. Total profits.

Mr. GEPHARDT. I understand. But query: Were there other profits that were put into other acquisitions in other areas, and did they put the money back into the kind of steel that we are being met by in competition with the Japanese?

To put it another way, I think what you are seeing is a high-technology investment in the steel industry. And query: If those investments are economic and can turn a profit for those companies—which I hope and think they can—do they need the kind of depreciation system and ITC combination that we have today, or would they not be better off with a system that is still generous, but not as generous, with a lower rate, with the hope that they are going to make profit and that they would pay a lower amount of tax on that profit?

Mr. SCHULZE. In response to Mr. Pease, it seems to me when—and I hope I am wrong—that your feeling is that if they cannot compete, even in the light of the very high dollar and extremely competitive foreign—whether it is subsidized or not, let's just say extremely competitive foreign producers—the response to that is, well, if they are having a hard time, we sit here in judgment and say, well, if they are necessary, we will subsidize them. And we end up with a British Steel syndrome, and in my opinion, it is just very dangerous territory.

We should not play God here on industries.

Mr. GEPHARDT. But Dick, that is what we have done on this committee through the years by putting in things like the combination of 1053 and the ITC——

Mr. SCHULZE. Absolutely, but we have not played God and said, "This industry survives, and this one goes." We jay——

Mr. GEPHARDT. But it is worse than that, it is worse than that. We have said we want to target this money at steel, whether it worked or not, and we also said we wanted orange groves to go from $3,000 an acre to $10,000 an acre, which is what happened the day after we passed 1053.

When you shoot with a shotgun, which is what we do here, you get all kinds of outcomes and results that we are not looking for.

Mr. SCHULZE. I think we also do the other way. Now, let us take the historic preservation tax credit, and let us say we eliminate it—and there might be a good case for eliminating it. How long do you think it will be before the mayors of Chicago, and Boston, and Philadelphia, and Baltimore will be in here, saying to us: "We need massive financial help to rebuild the inner core of our city"? And we will almost be forced to respond. Now, it seems to me it is a lot better to do that through the Tax Code, and there are certain areas that we have put in there where, for sociological reasons, we have determined that these things are good as national priorities.

So I do not think we throw out the baby with the bath water. I think we have got to be very careful when we do this.

Senator BRADLEY. If I could, the premise of our bill, and I think the premise of many tax reform bills essentially challenges that assumption, that we are better off with, as Dick said, a shotgun spewing goodies all over the corporate landscape and hope that we really are going to help a particular industry. I would argue that by spreading goodies over the countryside in the form of tax benefits if an industry is in trouble, and those tax benefits are available to everyone, as opposed to that particular industry, the comparative advantage of that industry is impaired. And therefore, it is not as efficient as going at it directly.

You raised the question about the steel industry. The steel industry is not paying any taxes because they are not making any profit. Therefore, whether it's tax incentives or tax reform, it is not relevant to them. If we went to tax reform, and they did start to make money, they would be paying at a lower rate of tax.

Mr. SCHULZE. Thank you.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Anthony will inquire.

Mr. ANTHONY. Thank you, Mr. Chairman.

I would just like to add my thanks and congratulations for what I think is a job well-done in focusing national attention over the difficulties, inequities, and unfairnesses of many provisions of our Tax Code.

I happened to watch both of you on one of the popular morning talk shows. I saw that you both had a very difficult time with the audience, trying to defuse the fact that you were going to take away special perferences in exchange for giving a lower marginal rate, and they seemed unconvinced. As you have traveled the country and as you have made your speeches, and since you have been the leaders on tax reform, what can you say to the committee and what can you say to this audience, that will convince them to trade their various tax deductions for lower rates?

Mr. GEPHARDT. Maybe the best way I can put it is that, to my knowledge, effective tax rates today under the present code are approximately between 12 and 28 percent. In other words, people are actually paying at those kinds of rates under present law. Obviously, the way they get to those rates is through the different preferences and deductions that in effect lower their rate.

What we are saying is that if that is where we are, why don't we start there, rather than going through the paper blizzard and all of the schedules and attachments and different things that are on the form to get your rate down; why don't we more or less start with that rate system, 14 percent for four out of five Americans, a top rate of 30 percent, which is essentially what we have got today, after going through all these contortions to get those rates down.

And when you say that to people and get them to focus on the fact that their rate would be 14 percent for four out of five Americans, and they would not have to keep all of these slips of paper, and have all of these accountants helping them put their returns together, it does make sense to people. And they do, I think, see the wisdom of giving up, perhaps, the fullness of their charitable contributions or whatever it is that they like in the code and going to a simpler and fairer code.

Mr. ANTHONY. Senator, did you have anything to add?

Senator BRADLEY. No.

Mr. ANTHONY. Regarding specific deductions.

Is there any reason to tax employer-provided benefits other than to broaden the tax base.

Senator BRADLEY. Well, let us take health insurance, employer-paid health insurance. I have opposed taxing that benefit as a source of revenue, and I will continue to oppose taxing it as a source of revenue. But I think the point that has to be made is that when you include these fringe benefits in income at the same time you are dropping the tax rates, 80 percent of the people who receive them will still end up with more money in their pockets.

For example, you are making $20,000. You have a health benefit that is worth $1,200. So you take it into income, and you are now making $21,200. But you are taxed at a 14-percent rate under the Fair Tax, as opposed to a 25-percent rate, so you end up with less taxes and more money in your pocket.

I think that that is one of the choices that the bill poses. In addition, I do not think taxing fringe benefits means that workers are not going to get health insurance. They are clearly going to get health insurance. They see their exposure. And with lower tax rates, they will have the means to buy appropriate protection. As long as group insurance is available, they will want and be able to purchase it and have more after-tax income at the same time. There's another aspect to this issue. Over 50 percent of married women are now working. Many of them could get employer-provided health insurance, but the problem is they are double-covered under the various health benefit plans, in most cases, double-covered. If only one of them had insurance, and they both had a lower tax rate on their wages, they would have more after-tax income and the same health coverage.

Mr. ANTHONY. There may be a way of putting more money in middle-income and low-income pockets to cover those 15 million that are presently not covered.

Senator BRADLEY. Pardon?

Mr. ANTHONY. We have about 15 million people who are not covered under any type of policy to begin with because their employers do not choose to cover them. Perhaps your bill will provide these people with the extra funds needed to buy those benefits.

Mr. GEPHARDT. Thank you.

Mr. GUARINI [presiding]. Mr. Heftel.

Mr. HEFTEL. I have no questions, Mr. Chairman.

Mr. GUARINI. Mr. McGrath.

Mr. McGRATH. Thank you, Mr. Chairman.

Welcome, Bill and Dick.

I have had a problem with the aspect of the entire tax proposals because of the elimination or, in your case, reduction of the value of the property tax deduction.

Bill probably knows that Al D'Amato in the Senate has been complaining loudly, along with Pat Moynihan, regarding this particular problem, that really, I believe, is probably exacerbated because of the high use of property taxes as a way to finance local government in New York, New Jersey, Massachusetts, and perhaps some other States.

What is unclear to me in proposing these kinds of deductions, that would have an impact on the way local government delivers services, is whether or not anybody is giving any study to what it does to the value of, let us say, any asset you may have, your house, your business, any land you may own, and also, how local government would perform the services that are performed at the local government level.

Has any study been done through either your proposal or any other proposal that may be forthcoming?

Senator BRADLEY. The only studies that I am aware of, and I could not name them now, but I have seen a couple, have been done by the jurisdictions involved to justify their positions.

This is clearly an issue where we do keep, or at least, do not eliminate, the deduction for State income and property tax. The Treasury does eliminate both of those deductions. We treat it the same as we treat all itemized deductions, as deductible against the basic rate of 14 percent.

I am not aware of any existing studies. I am sometimes puzzled by officials from high-tax States who argue against the bill on the grounds that they are going to lose this one little provision, or they are going to have less value for one little provision, because if you look at many States, their State income tax codes are tied to the Federal code, so that if we had a tax reform proposal that broadened the tax base, they would have a gush of revenues at the State level with which they could cut State tax rates, thereby making their State more competitive in the country. Alternatively, if they wanted to increase public goods and services, they'd have the revenues to do so without raising State taxes.

So I think you have to go beyond just the one initial burst of outrage, when you are told what you are going to lose, and you have to focus on what you are going to gain, as a State, a local municipality, or as individuals. And ultimately, it is a choice. I do not think our position is a theological position. It is a choice. The more preference you add back in, the higher the rates have to be.

Mr. **McGrath**. I just saw some numbers that came out of the Tax Foundation, that the average homeowner pays $386, I believe, in property taxes throughout the United States. I would submit to you that in my district, maybe the average is 10 times that. So we would be affected in a disproportionate way. And I am not sure whether any reduction in rate for any individual who pays that kind of tax would compensate for the loss of that deduction.

Mr. **Gephardt**. Again. I think, as I said, effective rates today are, I think—and my figures may be a little off—but I think they are between about 12 and 28 percent. Let us say you are at the top rate, and you do not have the full use of the deduction, as you would not under our bill, I think your rate would be about the same as it is today, even after you take the deduction.

I would, second, say to you that 70 percent of taxpayers do not itemize, so they do not even get the benefit, theoretically, of their property tax deduction. It is only going to 30 percent of the people to begin with. Now, I grant you, if a taxpayer has a $2,000 property tax bill and probably a mortgage interest deduction to go along with it, he is probably itemizing.

But again, I would say that 30-percent rate is probably about where they are right now after they get done taking all that stuff off.

Mr. **McGrath**. Thank you, Mr. Chairman.

Mr. **Guarini**. Thank you, Mr. McGrath.

I would like to thank you both for the dialog that you have opened up and the stand that you have taken against special interests which have increasingly benefitted by tax expenditures each year.

I certainly think that if we do not achieve a pure tax reform, we should certainly restructure our taxes so as to eliminate the abuses we have in the system such as the combined effect of ACRS and the ITC. We should restructure our minimum corporate and minimum individual tax, and perhaps work out a reduction of these tax expenditures that have really overloaded our system.

But I would like to get back to something that perhaps no one has asked yet: That is, how will the middle American make out? What does it mean, this tax reform, to the average working man? How does he stand and how does he come out?

Perhaps I could ask Bill Bradley to comment on this first.

Senator **Bradley**. I think the middle-income earner is a big winner in this. Let's take a typical family with two kids, and let's assume they are making $20,000, and they get a $5,000 raise. The husband or the wife takes a better-paying job, or gets a $5,000 raise. They are still only paying 14 cents on each additional dollar they earn.

Let us assume they get another raise, and they are now earning $30,000. Still only 14 cents. They pay 14 cents on each additional dollar they earn, all the way up to $40,000 in income. Plus they keep full deductibility for their mortgage interest, for their property taxes, for any charitable contributions they might make.

So that if you look at the middle-income person, if they were in the $40,000 income level with two kids today, they are paying at a 32-percent tax bracket. Under ours, they are paying at a 14-percent tax bracket. That says to families across America in income levels of $15,000 to $35,000 that if you work a little bit more, and you earn a little bit more, you are going to keep more. In my view, that is a powerful message, and I think it is a powerful constituency message over time, because things do not get worse, they get better.

Mr. **Guarini**. Does this build up the capital formation capabilities within our country as a result of their paying less income tax and therefore, being caused to, perhaps, save more?

Senator **Bradley**. I believe that. That was my argument earlier, that the greatest tax incentive for savings and investment is the lowest possible tax rate on profit. That is why we get it down to 30 percent at the top, and four out of five people pay no more than 14 percent.

Mr. **Guarini**. And out of that flows economic growth that is built into the program. Is that what you are saying?

Senator **Bradley**. Absolutely.

Mr. **Guarini**. Dick.

Mr. **Gephardt**. Well, we believe, to go back to your first question, that our bill results in either the same tax amount or a lesser tax amount for 79 percent of individual taxpayers.

Obviously, that means that the 30 percent who would pay higher taxes are the people who are the most highly sheltered. Therefore, we believe this kind of tax reform is really targeted at the middle-class family; the family on the short form, the family that is in that $20,000, $25,000, $30,000, $35,000 bracket. And that is one of the main reasons we worked on the bill, because we feel that group of people needs some basic incentive to want to earn more money, and that is the whole theory of what we have tried to do.

Mr. **Guarini**. Does this have—can you comment on any long-range implications on redistribution of wealth at all?

Mr. **Gephardt**. We do not feel, and the projections that we have run bear us out, that, the same amount of taxes will come from each income group, but, obviously, there will be a difference within the groups as to who pays the taxes. The people that are now highly sheltered will be people who will be paying more taxes, and people who do not use a lot of shelters will be paying less taxes.

Mr. **Guarini**. All right. Thank you.

Mr. Dorgan.

Mr. **Dorgan**. Thank you, Mr. Chairman.

I thank you both for your statements. Let me first say that I am a supporter of what you are trying to do.

The discussion earlier was on the subject of subsidy, and it seems to me that we have created certain subsidies in our Tax Code over the years to achieve certain purposes, but we never go back and evaluate with what efficiency has this subsidy operated or worked. And that has been one of the problems in the Tax Code. The result is 20 or 30 years later, or 10 years later, we discover that that old subsidy now creates distorted investment patterns. And as I understand it, your approach would attempt to—in response to Mr. Gregg's discussion with you—your approach would attempt to move back toward a marketplace decision on what is a good investment and what is not a good investment.

Is that the correct interpretation?

Mr. GEPHARDT. That really is the base theory of what we are trying to do in terms of economics and its relationship to the Tax Code.

The Tax Code started out being very simple. It was income, and then you took a percentage, and that was your tax. It was a very low rate when it started, and through the years, for all variety of reasons, different preferences, exemptions, what have you, came in.

In the last 20 or 30 years, we have gotten more heavily into economic planning, if you will, capital allocation mechanisms. The investment tax credit in the midsixties was the clearest example. We changed depreciation, as you well know, in 1981, dramatically, in order to get people to do certain things with capital. All of the provisions that have to do with various industries that we could talk about have been put in through the years to get a certain behavior to occur.

And you could argue well for any one of those in isolation. Many of them have made some dramatic changes in our society.

The question comes after 40 or 50 years of that—does the whole of it together really still make sense; and have we come to a point where there have been so many incentives put in, with so much attendant complication, that we really are injuring sound economic decisionmaking.

I was at a seminar recently where one of the captains of industry in the country said that he and his board did not make any decision in their business—this is one of the biggest companies in America—without having three or four tax lawyers at their arms making the decision based on tax consequences rather than economic consequences.

He said they bought a freighter line, even though they knew nothing about the freighter business, and did not care anything about the freighter business, simply because it offered them a series of tax breaks that would make their bottom line tax costs look better.

I think when you get to that situation—and I think that is where we are—you have really got to step back and ask is this what we want, and can't we roll some of this out of the code so that we really focus people—as I think we have got to in this country, in a competitive world, where we have got competitors who are coming at us with targeted industries to try to penetrate our markets—don't we have to have our markets work as efficiently as they can? And that is really what we are after.

Mr. DORGAN. Are there industries whose claims are legitimate when they tell us that the keys to the kingdom of economic growth are in retaining their special deal in the Tax Code? Are there industries whose claims are legitimate in that respect—because as you know, there are a good many claims coming from various areas, saying that this whole kingdom of economic growth as far as we are concerned rests someplace in the Tax Code, and if we do not keep ours, we are in big trouble.

Senator **Bradley**. Well, I think that kind of goes to the core of what you think is the engine of economic growth, and how important you believe efficiency in the allocation of resources is to achieving economic growth.

The premise of our bill—another one—is that the market is the most efficient allocator of resources. And it seems to me the People's Republic of China is coming to that conclusion reluctantly, but nonetheless they are getting there. That does not mean you do not address equity questions. You address equity questions, but you do it directly, and not, as Dick has said, with a shotgun approach.

What we try to do is—imagine if there were no taxes. Where would you put your money, and how would you invest to make money? Essentially, we want the Tax Code to be as neutral as possible, so those are the driving decisions of your investment policy.

Are there any special pleaders who have legitimate cases? Well, I do not know. Maybe in the course of this debate, we will see some that will come before the committee with a very thorough brief that will be analytically flawless, that will be powerfully argued, and maybe they will make that case persuasive.

I will only tell you that our experience is almost the opposite—that support for this kind of concept is coming from groups that you thought would oppose it. Two weeks ago, we did a little thing with seven or eight corporate people. The press being the press—I mean, I said some of the corporations represented here will pay more, some of them will pay less—the press being the press asked me, "Well, who pays more?"

I did not know, really, if any of them paid more, but three of them raised their hands and they were asked, "Well, why are you for this tax reform if you pay more tax?" And their response was as follows. The first: Because I think the whole economy in this country will be strengthened by tax reform. And we are all better off with a strong economy.

The second: We will pay more the first year, maybe the second year, but with a lower rate, since we are pretty good at what we do, as we earn more, we will keep more.

So, I think there are powerful arguments for it.

Mr. **Dorgan**. If I might make the observation, I have been around a couple of CEO's recently whose companies have suggested that there are all of these problems with simplification and tax reform who, in an aside, would say very quietly, "The hell with all that; just pass this, and simplify it, and lower the rates, and we will be better off."

I think there are a lot of CEO's who believe that——

Senator **Bradley**. But the key is you have got to get past the executive vice president for tax policy.

Mr. **Dorgan**. That is probably true.

One final point, Mr. Chairman. The point raised by Mr. Gregg is an important one, and I think, since I support your position, I share the observation that you made some provisions in your proposal that someone who is dealing with theory might not have made allowances for. And I suspect it is an attempt to succeed in passing something that is excellent, as opposed to failing and passing something that is perfect. And anybody who understands the danger that we face with this Tax Code understands that we need to succeed in passing something that is good.

Mr. **Gephardt**. Thank you.

Mr. **Guarini**. Thank you, Mr. Dorgan.

Barbara Kennelly.

Mrs. **Kennelly**. Thank you.

Thank you, Senator Bradley and Representative Gephardt, because I think you have really brought to the country the notion that we could have tax simplification. You are the originators of the proposals circulating, and a lot of us remember that.

You are living with tax reform day in and day out, and thinking about it probably more than any other two individuals. You have talked to the administration; you have talked to the Treasury.

I know it is safe to say a number of people in this room did not think 2 months ago that much was going to happen on tax reform, and they are of a different opinion right now.

Can I ask the two of you what you think the chances are of a tax simplification bill this year?

Mr. **Gephardt**. I think the chance is good. The conventional wisdom would be that this cannot be done, that it is too much political heavy lifting and that eventually, it will all fall apart. But I see the seeds of success, for the following reasons.

One, this really has been a bipartisan effort. There are lots of bills out there under different party labels, but they are essentially in the same direction. They are restorations of the base so you can lower the rate. And I think that is an important ingredient. I do not think any political party can take a bill and run it through the Congress and get the President to sign it. I think it has to be an effort that really goes across the aisle and involves a whole cross-section of people in the Congress.

Second, I think the President is very much for a tax reform effort, and I think that he will send down here in the next few weeks a specific tax reform proposal that he will be for and say that he is for and that he will work for.

Third, as we have said before, I think there is deep grassroots support among individuals and corporations for this to happen. And I think the moment of truth will come in the committee and on the floor, when the lobbyists are most intensely lobbying to defeat any bill. The question then will be, will the people of the country who really want this send in cards and letters and make telephone calls and talk to their representatives to say that, "Yes, we are willing to give up our particular favorite deductions in order to get the rate down." If that happens at that time, I think a bill can pass. If it does not happen, then my projection is wrong.

Senator **Bradley**. I agree with Dick. I think that we have a remarkable opportunity, and that remarkable opportunity continues to the August recess. I think there is still a possibility if we do something in September, and October, and November, but it becomes less probable as time passes. It depends on how actively the President is going to involve himself in this process of posing the choice for people.

If we had what in economics is called perfect competition but in politics is called perfect communication—in other words, the ability to explain yourself to the American public—there is no doubt in my mind that all the groups that are arguing for the narrow interest would be defeated by the group arguing for the general interest. The President of the United States has the capacity to do that every night on TV.

So I think there is a very real possibility. I might also say that I am not so sure whether the political process has realized that tax reform is not defense; it is offense. And I am not so sure whether that realization will come slowly, or whether it will come quickly. I hope it will come quickly, because I think this is something that the American people will rally behind once the choice is posed for them.

Mrs. KENNELLY. Senator Bradley, one more thing. I read an awful lot of what you say on tax reform and I know you are committed to this, and you think if it does not happen now we are going to have a tax revolt.

You are having the same problem on the Senate side as we are having on the House side on cutting the deficit. Do you think, having gone through that process during the last few months, that if we have tax simplification next year, it will be tied in with revenue-raising, because it is so difficult to cut that deficit?

Senator BRADLEY. Well, you know there is an old saying in, I guess it was Maine, but it could be adapted to New Jersey, about someone who comes up to a local resident and says, "How do I get to Camden?" and the reply is "You can't get there from here."

And I guess I would say if it is going to be turned into a revenue-raiser, somebody is going to have to step forward and say it. And it is my sense of the Democrats that we are not going to step forward and say it; it is my sense that the President is not. So I do not know who it is that is going to step forward and say this has to be a tax increase.

Our premise is that we are revenue-neutral in the first year; over time, we raise revenue through improved efficiency.

Mrs. KENNELLY. Thank you, Senator.

Mr. GUARINI. Do you think it would be less likely with the Senate up for election next year, that there would be a——

Senator BRADLEY. I thought you were going to say would it be less likely if we had said how to get to Jersey City.

Mr. GUARINI. All roads lead to Jersey City.

Senator BRADLEY. For me, that's true. [Laughter.]

Mr. GUARINI. Mr. Daub.

Mr. DAUB. Thank you, Mr. Chairman.

Well, I have always been fascinated by the idea that marginal rates were, over a period of time, although difficult to explain, the key to effective tax reform.

I look at your bill—may I say, it has to have been a challenging experience for the 3 years you have been involved in this, and we welcome you to our hearing today and know of your sincere interest in the cooperative spirit that is going to have to prevail to get this impossible trip to Camden negotiated. How do you raise your revenue in your bill—if you keep so many of the deductions that are currently in the law—we have to throw out the idea of simplification, don't we, and just say this is really reform. How do you raise your revenue? Do you get rid of all the depreciation? Do you get rid of indexing?

What are the keys to the revenue side of your bill?

Senator **Bradley**. We eliminate 43 to 44 tax expenditures. Now, I can read you the whole list of those, if you want me to. It is easily obtainable.

The value of all loopholes is about $370 billion this year. We do not eliminate all of them, but we eliminate a good number of them, and with the revenue that is thereby derived, we drop the tax rate.

Mr. **Daub**. Do you have a model on your bill that takes those 43 or 44 tax expenditures—Mr. Curry's favorite words—and shows how they are changed over this 5-year period?

Senator **Bradley**. Well, they are eliminated.

Mr. **Daub**. They are eliminated—but what the consequence of that is when they are eliminated.

Mr. **Gephardt**. Do you mean an econometric model?

Mr. **Daub**. Yes.

Mr. **Gephardt**. There are a number of econometric studies that have been done that say what happens to the economy under present law, what happens to the economy under tax simplification. And as I said earlier, some of them show the economy does better, in terms of leading indicators under tax reform, and some say it does worse. It really depends upon your assumptions as to the economic consequence of taking out these 43 and bringing the rate down. And what you put into your econometric model in terms of assumptions drives what the outcome is. To put it another way, it is everybody's good guessing.

Mr. **Daub**. If 70 percent, as you were saying, Dick, file the short form, then are we saying that the 30 percent who can itemize are the ones that are going to pay higher taxes?

Mr. **Gephardt**. Not necessarily. There may be some, but obviously, the greatest number would come from that itemizer crew, because they are the ones that are making the best use of the shelters.

Mr. **Daub**. Let's take 401(k), or let's take insider buildup on life insurance. How do you view those? Are they tradeable for this lower rate, like the accelerated depreciation or the ITC are tradeable for the lower rate on the business side?

Mr. **Gephardt**. I think as you go through this exercise, as we go through it in the committee, what you will find is what we found 3 years ago, and that is as you go through each one of these, you make a judgment on what you think is vital in terms of the economy, what is vital from a political viewpoint in order to get the bill passed. And once you have gone through that, you see how far you can bring the rate down. And if you are not willing to make the judgment that anything can be taken out, then you cannot get the rate down. It is a real simple exercise.

Bill and I had a lot of arguments in the bill on what we would take out and what we would leave in and how we would leave it in. We are probably still arguing about some of them even now. But you finally have to make a judgment, take a vote—and we had trouble voting, because there were two of us, and we had a lot of ties—but at least we made a judgment, and we got the rate down to 30 percent and 14 percent.

Mr. **Daub**. How did you decide when there was a tie vote?

Senator **Bradley**. That is privileged information.

Mr. Daub. Did you leave it in? It stayed in, right?

Mr. Gephardt. That's right.

Senator Bradley. Whatever you want. Let me come at another aspect of this. As Dick said, you have got your list, the value of all the expenditures. You either get your rate lower by eliminating a given preference, or you have your rate higher by keeping it.

There is another aspect of this, and that is, if you recall the principles that we set out, one was that you do not increase the deficit. That is why the rate and the loophole revenue numbers are relevant. The second principle, though, was you do not increase the relative tax burden on middle- or low-income people. And that means that if you put back in a provision that benefits one income group over another, that distorts what you want, which is neutrality in the distribution of income.

So it is a double balance here. It is a revenue balance, and it is a distribution balance—both of which have to be met.

Mr. Daub. Excuse me. My time is just about up. Let me get in one more question. I appreciate that.

Is there any shift—yes or no, if you can—between income from the individual side of your proposal and income from the corporate side?

Senator Bradley. No.

Mr. Gephardt. No.

Mr. Daub. So, you are going after, then, mostly individual increases in income taxes as a tradeoff in your bill?

Senator Bradley. And corporate, and corporate.

Mr. Gephardt. We are neutral. We do not take any more money from individuals than we do today. We do not take any more money from corporations than we do today.

Mr. Daub. The mix stays the same; there is no shift?

Mr. Gephardt. Right.

Senator Bradley. I might say, also—you asked about the overall effect and the econometric models. The latest study that was released was released last week, done by Alan Auerbach at the University of Pennsylvania, who is one of the country's foremost authorities on capital formation. And its conclusion was that the efficiency gains from our bill's enactment would be over $6 billion annually. And I do not think that is an insignificant number.

Mr. Daub. I saw it, and I think it was a most impressive conclusion, too.

Gentlemen, thank you very much.

Mr. Chairman, thank you.

Mr. Guarini. Mr. Campbell.

Mr. Campbell. Thank you, Mr. Chairman.

I want to follow up just a little bit on the question that was started there. Your bill now says 70 percent of the people are going to be in the lower tax bracket, correct—or, pay lower taxes?

Mr. Gephardt. The same or less.

Mr. Campbell. The same or less.

Let me ask you this. How many of the people today would fall in the 14-percent category?

Mr. Gephardt. Four out of five Americans, or 80 percent.

Mr. Campbell. How long does your bill take to push them into 25 percent?

Mr. GEPHARDT. That would depend upon what happens with inflation.

Mr. CAMPBELL. All right. Let's assume a rather low inflation rate, historically, taking the last 10 years or so and averaging it at about 5 percent. If you do that, isn't it true that you are going to have more than half the taxpayers above that level of 25 percent within a period of about 4 years?

Mr. GEPHARDT. Well, obviously, that is the case if you extrapolate it out, and you assume Congress does not intervene at some point and change the rates.

Also, obviously, you could decide to index——

Mr. CAMPBELL. But you did not decide to index. You did not index brackets, you did not index any of the things in the bill that would protect the taxpayer from being pushed into a higher tax bracket; is that not true?

Mr. GEPHARDT. That is true.

Mr. CAMPBELL. You raise your revenue over the taxpayer being pushed up the ladder after the third year; isn't that true?

Mr. GEPHARDT. There is some increase in revenue from Bradley/Gephardt because of the lack of indexing.

Mr. CAMPBELL. I took several tax returns and took a good look at them, just odds and ends, ran them up and down, averaged, figuring what a family might do and might not do. And I find with some interest that after you have applied, say, 5 years, or even if you take the current law and look at a two-earner couple at about $35,000, somewhere in that range, that they in fact have a tax increase—if they took the deductions now allowable to them, that they have a tax increase of roughly 14, 15 percent next year. If you apply beyond that, the 5-year period, roughly don't you come up with about a 20-, 23-, 24-, 25-percent increase in taxes on that middle-income wage earner?

Senator BRADLEY. How much is their income increasing each year?

Mr. CAMPBELL. I am going to have to say if you maintained a static income, because you do not protect them from inflation, and figure nothing but the inflation at 5 percent, and they maintain a static real income on it. You raise their taxes dramatically.

Senator BRADLEY. Let me say to you that when you deal with the question of indexing you have a legitimate concern; it is a concern that we certainly had, and it ultimately drives you toward what the Treasury did in their proposal.

Now, if you are going to index tax brackets, that is fine. You are then going to be driven to indexing everything else that the Tax Code affects, if you are really going to get neutrality. And that leads you to indexing the basis for capital gains—which is fine; I voted for that—this will lead you to indexing interest—which becomes problematical, to say the least. It leads you to indexing depreciation, which might be a good idea. But if you are going to go the indexing route, you have to go to the logical conclusion, or you are simply distorting things.

And I understand the appeal of being able to say to someone, "You will never be forced into a higher tax bracket." We get at that another way, though, by saying instead of 13 brackets, you have only 3 tax brackets.

Mr. Campbell. But Senator, you push them out of 14 percent and over 25 percent in a very short period of time. You have no indexing. And only if you assume that the Congress is going to come back and roll back, or change the brackets, after 3 or 4 years—if you make that assumption, your argument is very, very plausible. If you do not make it, you are raising the taxes on all of these people.

Senator Bradley. Let me say that I really want to take a look at your numbers that you are asserting, and take a very close look——

Mr. Campbell. Well, let's just take your numbers.

Senator Bradley. I agree with you, as a hypotethical possibility, yes.

Mr. Campbell. OK, all right.

Let me take your actual. You said in your earlier testimony that you would raise about $30 billion in the third year; is that right?

Senator Bradley. That is right.

Mr. Campbell. What assumption did you make in that for inflation?

Senator Bradley. We took the Treasury Department study and the CBO, that tells us that 4 years out, the value of ACRS will be *x* billion. We change ACRS——

Mr. Campbell. But there was an inflation assumption in all of this calculation?

Senator Bradley. Sure. It's what the Congress is officially projecting for all its budget numbers. We used a concensus projection for inflation, just as Congress and the administration do for all fiscal policy formulation purposes.

Mr. Campbell. Well, I would love to see your inflation assumption, or what you have done, and let me have it for the third, fourth, and fifth years, and tell me how much revenue you are raising off of the different taxpayer groups. I mean, use yours; don't use mine, because I am for a lot of the simplification, a lot of the things that you are—I am concerned about capital formation, I am concerned about risk capital. But I am more concerned about what appears to me—and I may stand to be corrected, but I do not think so—what appears to me to be a massive tax increase over a period of about 5 years on the individual average middle-income taxpayer in America. And that is what I want, if you could provide it, because I would like for you to prove me wrong so we can move on down the road. But I do not think you can.

Senator Bradley. Well, I think that is fair enough, and we can certainly provide that, and we will also provide the benefits to the middle-income person who is not pushed into a higher tax bracket because of a 14-percent rate all the way up to $40,000 in income.

Essentially, what you are saying is the middle-income level begins when you go above $40,000.

Mr. Campbell. No, I am not. I am saying that the middle-income today, that single individual that jumps into it at $25,000, could be at 20 today, and they are going to be in it in a couple of years. I am saying that that middle-income family at $35,000 is going to be into it in a couple of years.

That is what I am saying.

Mr. GEPHARDT. I think, Carroll, you have identified what is going to be a raging debate in this bill, and it is not only the indexing of the brackets. It is the indexing of interest, and capital gains basis, and depreciation. And they are all going to have to be thought through as we go through this.

Mr. CAMPBELL. Well, my real concern—and my time is up—is that you are limiting—No. 1, you are limiting your deduction to the 14-percent level—home mortgage, everything else—but you are letting that taxpayer be pushed into a higher bracket. So essentially, you are taking away from them on one end and letting them get pushed up, and that bothers me. If you were not going to do that, why didn't you look at letting the deduction go up with them? If you were going to try to stay revenue neutral in this thing, if you were going to try to deal with it that way. And perhaps we should look at all that.

Mr. GEPHARDT. We certainly will. When we debated this among ourselves, our concern with indexing, as Bill said, was if you do it with brackets, then aren't you forced to have consistency throughout. Maybe you are not, and maybe that is a decision the committee will want to make.

Mr. CAMPBELL. Thank you very much.

Mr. GUARINI. Thank you, Mr. Campbell.

Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman.

I want to congratulate both of you gentlemen for the work you have done toward trying to simplify an overly complicated progressive income tax system. I think we could get into a philosophical debate on the whole question of progressivity versus proportionality in taxation, and that is where I think the whole debate on fair or just taxes really lies.

But I still congratulate you for coming up with a forward positive step to join in an ongoing debate on both sides of the aisle.

I would just like to echo, as the original author of the indexation bill back in 1974, and one who waited 11 years to see indexation of the code finally become reality, the concerns of my colleague from South Carolina. And if you talk about, at some point down the line, Congress coming back and making adjustments to compensate for the erosion of the purchasing power of the dollar and the bracket creep phenomenon and people being pushed into higher tax brackets, it seems to me that is a real invitation to Congress examining a lot of the other salutary reforms included in your bill, because in the process of trying to seek to provide equity and justice because of the injustice of bracket creep, you are going to have, I think, a lot of our colleagues, almost immediately with any reform bill adopted, finding a constituency out there that rationalized and justified the various provisions that we put into the code for this group or that, coming back with great power and force and a mobilized lobbying effort to try and restore that lack of justice that they perceive in the code.

I did some study—and I am quoting from memory now—but in 1965, my recollection is that there were approximately 40 million joint returns filed. The number of joint returns in the 28-percent bracket at that time was about 1 million out of 40 million. By 1985, the projections are about 43 million joint returns filed, but the number of people who have moved into the 28-percent bracket now is about 20 million. And that is the concern I have about a code that is fair and just has to acknowledge, as the committee did when our chairman recommended a freeze on indexation from 1985 to 1989, through fiscal year 1989—and the staff tells me that that would have produced about $95 billion in increased revenues just in this 4-year period we are facing. And if some of the horror stories about what could happen in terms of the value of the dollar if we do not address budgetary concerns, if that actually occurred, I think it could be well before the end of the century that virtually every working American ended up in the 30 percent bracket rather than the 14 percent bracket.

That, it seems to me, is the real Achilles heel in your proposal, because I had Walter Heller at a business conference with me about 2 years ago in my district, and Heller, of course, was recommending repeal of indexation before it came on, as a revenue raiser. And then he kind of slyly grinned and said, "Admittedly, it is a stealthy way to raise taxes."

I would argue that it is also an immoral and dishonest way to raise taxes; that we, as elected representatives, have the obligation, if we feel new revenues should be produced, to be upfront with the people about it, because they do not understand bracket creep.

And I think it was Grace who showed those figures that the median income at the end of World War II by 1948 was under $5,000 per year. That person paid an average of $9 in Federal income taxes, and today it is about $25,000 as median income, and that person is paying about $2,500 on average.

Now, even allowing for the deterioration of the purchasing power of the dollar, that is a significant increase in the total tax burden of middle-income Americans.

So let me congratulate you—we have got to run and vote, but I want to congratulate you for your contribution. But as said, I think that is the one flaw in the whole proposal. Otherwise, it has a lot to be applauded, and I certainly applaud your efforts to simplify the code.

Thank you for being here, too.

Mr. **Guarini**. Thank you, Mr. Campbell.

Mr. Donnelly.

Mr. **Donnelly**. Thank you, Mr. Chairman.

We are playing "beat the clock" here, Bill and Dick. I just want to state that I completed a survey of my district, and 73 percent of 10,000 respondents felt that the present tax system treated them unfairly.

Senator **Bradley**. Unfairly?

Mr. **Donnelly**. Right, unfairly.

Senator **Bradley**. Seventy-three percent?

Mr. **Donnelly**. Seventy-three percent of 10,000 respondents felt that the present system treated them unfairly.

That, to me, is a frightening statistic, and I think that ought to be the motivation for this committee and its counterpart in the Senate to move forward with some sort of tax reform or tax simplification.

I strongly believe that the entire code has to be rewritten, that each section of the code has to justify itself and has to stand on its own two feet. But I guess the fundamental question that I am still wrestling with is that if we use your bill as a vehicle, clearly, in the real world, as it goes through the process, it will change. Exceptions will be added.

The question is, what are the criteria that, as we go through the process, we use as a committee and as a Congress on deciding what is in and what is out? If it is a system where only the strong survive, only those sections of the code that are the most ably represented here in Washington, or have the most powerful lobby at home, I am afraid we will end up with a tax code that will still have 73 percent of the people saying that it treats them unfairly.

I really think we need to tie down criteria for inclusion and exclusion on any tax simplification or tax reform.

Do you have any quick comments on that?

Senator **Bradley**. Yes, I could offer a couple. I think one is, if you can assure people—if you start with a base, a bill—let's say it is ours——

Mr. **Donnelly**. Using your bill ~~as~~ the base, then.

Senator **Bradley**. OK. We do not increase the relative tax burden on middle- or low-income people. Let's say, for example, somebody says, "Well, let's put back in provision 'x'." The first thing you have to ask yourself is does it increase the relative tax burden on middle- or low-income people.

The second thing you have to ask yourself is, well, if you put that back in, how much will that increase the deficit, or how much higher will we have to raise the rate.

The third question is how much will this complicate things.

You know, you get people coming in and arguing not just growth benefits, but equity benefits, that complicate everything, and it complicates it excessively, and you end up with a worse system than you started with.

So I think that the criteria should be its effect on the deficit, its effect on distribution, whether the complexity is indeed worth whatever the purported benefit is supposed to be from the person who is proposing it; and third, what kind of rule of reason, common sense—I mean, do you really believe that if you have a tax credit for a wood stove that that is going to end the energy crisis? I mean that was the basis upon which we put it in the code. Or, take another one that is a little hotter—oil depletion. When was it put into the code? It was put in in 1918. Why? Because the people who proposed it said we need oil to win World War I. When was it passed? In 1919, after the war was over.

And then, as every year passed, you added something else to that long list of things that have a depletion allowance. The rule of reason, common sense—the deficit, distribution of income, complexity. Those are the criteria that I would use. And the most important one in the end—how low can you get the rate.

Mr. **Donnelly**. Thank you.

Mr. **Guarini**. Thank you.

The Chair wants to thank both of you and commend you for your efforts and for the great dialog that you started in our Nation in this very critical area. We appreciate having the benefit of all your thinking and hard work.

We will suspend the Chair. Cec Heftel will be the next witness at 12:15, followed by Jack Kemp immediately after, and then Senator Roth will be here at 1:30.

Thank you very much, gentlemen. Thank you, Bill Bradley. Thank you, Dick Gephardt.

[Short recess.]

Mr. GUARINI [presiding]. The committee will reconvene.

I would like to welcome our colleague, Cec Heftel, a highly regarded businessman and one of our most respected colleagues.

Mr. Heftel.

STATEMENT OF HON. CECIL (CEC) HEFTEL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF HAWAII

Mr. HEFTEL. Mr. Chairman, I am delighted at this opportunity to participate in the hearing on tax reform. Just doing that is a great accomplishment, I think, for Congress and for the committee.

In terms of reform, I think that perhaps the cash-flow tax may be the ultimate. It may also be more reform than we are capable of handling at this time.

Nonetheless, the cash-flow tax has one distinct advantage. It taxes what we consume, rather than what we spend. If there is a reward, it is on a level playing field, and it is for all in the society to participate in; namely, the benefit from savings and investment, because that is the way that the tax is designed. Until the time of death, all of that which you rollover, all of that which you continue to reinvest, is not taxed.

Now, I could go into great detail, but I will not at this time. I will ask unanimous consent merely to summarize. But I think that it is critical that we be aware that if we are concerned with capital formation, if we are concerned with capital growth, if we are concerned with productivity, the cash-flow tax has much to offer. Most certainly, it is one way of assuring the fact that the taxpayer will learn and the society will learn the reward for saving and investment; that in turn should bring down interest rates, and that in turn automatically increases the rate of productivity.

The other factor that I want to briefly cover with the committee and you, Mr. Chairman, is the question of credibility. We have been talking about tax reform, fairness, an even playing field, and what we do for the middle-American taxpayer, and we do it on the premise that we will on the one hand take away, but on the other we will lower the tax rates because of the broad base. And as a result, some 70 percent of our taxpayers may in fact, incur a tax decrease.

What we are not focusing on is what the deficit is going to do, to what Congress must do, relative to taxes in the next few years. One of my concerns, regardless of what plan we ultimately adopt, if we do, is the possibility that middle America is convinced that tax reform means fairness and lower taxes for them. They give up so-called fringe benefits, which most certainly are not loopholes—and you talk about health and insurance and child care centers and that type of fringe benefit—and then find that their tax rates are increased—in addition to the fact that if you have no indexing, they will increase automatically, effectively.

So my concern is that we be very candid with the American public, and make them realize that if the budget stays at its deficit position, there is no question we will have to have tax increases, and that that which we are telling them today is an inducement to accept fairness under tax reform may change in terms of what happens with ultimate tax increases. And it is that which would concern me the most about credibility, and what would happen to an American public who, if they are not disillusioned with our tax system, would most certainly be very disillusioned to find that they had been induced to accept a system which ultimately led to higher, rather than lower taxes and deceived them in its original passage.

I thank you for this opportunity to appear before the committee.

[The prepared statement follows:]

STATEMENT OF HON. CECIL (CEC) HEFTEL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF HAWAII

Mr. Chairman, I appreciate the opportunity to testify before your committee today to discuss the need for reform of our current income tax system.

Whatever approach to reform we take or whichever proposal we adopt, we should be sure that it provides adequate stimulus to investment, savings and capital formation. Our economic recovery is very fragile. We cannot afford the luxury of passing a reform package that inadvertently triggers an economic downturn by increasing the tax burden.

The taxation of cash flow is best suited to ensuring economic growth since it provides that best incentive for savings and investment. Under the cash flow income tax system, all income is taxed once—either at the time of consumption or at the time of death in estate tax form. Cash flow tax can be deferred as long as one's lifetime, providing the stimulus for capital formation. The formation of capital will result in positive, long-term economic growth and enhanced employment.

I have introduced a cash flow tax bill, H.R. 1165, which would tax people not by how much they put into the national product, but by how much they take out. My cash flow tax bill is designed to maximize investment and savings. This will, in turn, increase the amount of available domestic capital, which will permit us to become less dependent upon foreign capital.

In this bill, annual cash flow is derived by calculating the value of total receipts in the year using the W-2 and 1099 forms as presently used. From that value is subtracted the amount of net savings and investment made by the taxpayer during the year. The difference between what was received and what was saved over the year is cash flow—the tax base.

It is necessary that the taxable base of the cash flow tax be broader than that of any income base since consumption by definition is smaller than income. Thus to raise adequate revenue levels, the tax base on a comprehensive cash flow base would have to be higher than that on a comprehensive income base.

A limited number of deductions, or a standard deduction, would be subtracted from adjusted gross cash flow [AGCF], and graduated tax rates would be applied to that taxable cash flow.

Deductions allowed to be subtracted for individuals include: (1) Mortgage interest payments on principal residence and interest on indebtedness for purchase of investment assets as well as that incurred in the conduct of trade or business (whether personal or partnership); (2) medical expenses in excess of 5 percent of adjusted gross cash flow; (3) charitable contributions up to 5 percent of an individual's adjusted gross cash flow; (4) State and local income taxes; and, (5) uninsured property losses in excess of $500.

We provide for zero bracket amount deductions of $4,000 for individuals, $6,000 for heads of household, and $8,000 for joint returns. A tax credit of $200 is included for each dependent claimed.

This proposal contains three progressive rates, taxing a family of four beginning at a level of $12,000 in consumed income. The rates will be: 10 percent, for married individuals filing jointly up to $15,000 in consumed income, and unmarried individuals up to $12,000; 23 percent for married individuals filing jointly and unmarried individuals up to the Social Security wage base; and 30 percent for those above the Social Security wage base. The indexing of the Social Security wage base provides for automatic indexing of the 30 percent rate. Language to index other individual rates is included in the bill. Meanwhile, corporations would pay one rate of 30 percent on retained earnings, net of dividends paid out.

The bill would repeal most of the current credits and deductions provided for businesses and individuals. Depreciation for property placed by the corporation during the taxable year would be expensed or subtracted to arrive at adjusted net income. As an offset to the expensing of depreciation, which is most attractive for capital formation, current deductions for capital gains, investment tax credits, and foreign tax credits would all be repealed. Similarly, fringe benefits, such as contributions by employers to health and life insurance plans, would be included in the individual's taxable base. The amount of medical insurance added to the taxable base would likewise be applied toward the 5 percent of adjusted gross cash flow level necessary for the medical deduction. Deductions for real and personal property taxes would also be repealed.

The true stimulus for savings and investment would be derived from the fact that all amounts, including capital gains, dividends, and interest, would not be taxable as long as they are saved or invested or reinvested. By permitting tax deferred reinvestment of these amounts the economy benefits through increased capital formation.

A cash flow tax system would simplify our tax code by repealing the loopholes listed in today's massive number of deductions and credits. Expensing of depreciation and incentives for savings and investments will provide the mechanism for the increased capital formation needed for revitalization of American business.

A cash flow tax system is workable, simple and effective in developing the capital necessary for long-term economic growth.

Regardless of what tax reform plan we eventually adopt, we must conduct our deliberation under an umbrella of candor. Although public opinion polls indicate that a majority of Americans embrace the concept of tax reform, they do not want it to be used as a smokescreen for raising taxes.

Some tax reform proposals, for example, will tax fringe benefits in return for lowering tax rates. It would be irresponsible for us to entice the American people into supporting such a reform plan under the guise of reducing their tax burden in 1986, if we intend to raise their tax rates in 1987 or 1988. If that occurs, the American taxpayer will find himself in a worse position than he suffers under the present tax code. If we don't treat the American public with the honesty and candor they deserve, we will be faced with far greater disenchantment with our tax system than we currently experience.

Mr. Chairman, thank you for this opportunity to testify.

Mr. **Guarini**. Thank you, Cec.

Do I understand, then, that tax reform should be accompanied by revenue raising? Is that what you are saying?

Mr. **Heftel**. I think it must be honest in the way it addresses the question of revenue raising, of revenue increases.

I do not think we should act as though we will not raise taxes, and we are going to solve our problems through this tax reform, which has been implied. We should not broaden the tax base to raise revenues so we do not have to say we are raising tax rates.

And I think to the extent it is false, it would mislead the American people at a time when we have got to be candid with them on so-called tax reform and what we do about the deficit.

Mr. **Guarini**. I share with you the belief that our first priority is the national deficit. It is perhaps more important than any other single issue we have facing us. Does your proposal rearrange the wealth of our Nation?

Mr. **Heftel**. It does not rearrange the wealth. It just rewards investment and savings. And those who save more and invest more will ultimately gain more wealth.

Now, the wealthier then have more potential. But they always do. It is no different than it is under the present system. What it does assure is that everybody will be paying their share at their bracket of what they consume.

Mr. GUARINI. The thrust of your bill more or less is similar to the thrust of Senator Roth's bill, where capital formation is synonymous with economic growth?

Mr. HEFTEL. It is comparable in certain features. His is a partial measure; mine is a total measure. He takes it in steps because he is afraid the system is not ready to assimilate the entire movement to a cash-flow tax.

Mr. GUARINI. All right, then. If a man makes $40,000 a year, and he spends $30,000 a year, he would pay taxes on the $30,000; is that correct?

Mr. HEFTEL. That is correct, that is correct. He pays on that which he spends.

Mr. GUARINI. Now, a man makes $40,000 a year. And he went out and he spent the $40,000. How are we going to collect the tax from him, if he has no money? Is this another welfare case?

Mr. HEFTEL. We have a W-2 form system that will take care of all that. Let me put it this way. Mechanically, it can be taken care of. To take the time now, I do not think is productive. But it is important to realize that the W-2 form can operate in the cash-flow tax just as it does at the present time. There is an estimate of income, there is an estimate of expenditure, and there is a tax based upon those assumptions.

Mr. GUARINI. So you still have a withholding tax, an estimated tax, and things of that sort?

Mr. HEFTEL. That is correct.

Mr. GUARINI. Thank you.

Mr. Pease.

Mr. PEASE. Thank you, Mr. Chairman.

Cecil, I appreciate your testimony and your initiative in coming forth with this proposal. I have a comment, and then a question.

The comment is about your remarks relating to being honest with the public. I think you have put your finger on a central dilemma of this year. Clearly, if we do a tax reform package this year, which does not increase revenue—and it seems that that is the ground rule that people are insisting on—then, to solve this enormous deficit problem we have, Congress is almost surely going to come back later this year, next year and the year after and increase revenue, and people will think that we have betrayed them, as you suggest.

What is the way out of that? Are you suggesting that we ought to combine tax reform with revenue raising so that it is all there in one package, and the public knows what it is getting?

Mr. HEFTEL. I think we have to at least say that unless tax revenues without an increase—increase the net revenues of the Federal Government—we will have to resort to tax increase to do so, and that there be a combination of understanding that reform on the one hand is desirable, but tax increases may ensue quickly thereafter. And somehow, that point has got to be made, because otherwise, we will have deceived people in a way that I think would be very unfortunate, because if we think they are disillusioned with the tax system now, what will they think if we give them reform, take away fringe benefits for middle America, and then go into tax increases which put them in a worse position than they were before tax reform—with no alert and no warning to them of what may ensue.

And I found no problem in discussing it this way with my constituents. They do really understand that somehow, that deficit has to be taken care of, and they are willing to understand what this means. But so far the whole premise has been that somehow we will have tax reform, and somehow, the deficits will get taken care of, and we do not have to worry about it. And I do not think it can happen that way.

Mr. PEASE. I think the next witness is probably going to tell us how we can do all of these things without increasing taxes.

Mr. HEFTEL. I will be delighted to listen.

Mr. GUARINI. Mr. Gregg.

Mr. GREGG. No questions.

Mr. GUARINI. We thank you very much, Cec.

I would like to welcome our highly respected colleague, and one who has taken a leadership role in the tax field for many terms in Congress now, Jack Kemp.

Jack, we welcome you here.

STATEMENT OF HON. JACK F. KEMP, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. KEMP. Thank you, Mr. Chairman.

I appreciate the friendly welcome.

Mr. GUARINI. We hope that everybody will be coming back from the vote.

Mr. KEMP. I am sorry that one of our colleagues asked a question and did not stay to find out what the answer is.

Mr. PEASE. I have not left yet.

Mr. KEMP. I am looking forward to your participating.

Mr. Chairman and members of our committee, I am particularly grateful for this opportunity to testify in favor of a comprehensive Federal income tax reform in 1985.

Until recently, the main question about tax reform was whether we would have it at all. But now it is increasingly clear, Mr. Chairman, even to opponents of tax reform, or proponents of the status quo, that there is a broad, emerging bipartisan consensus to reduce the tax rates, simplify the code, and encourage economic expansion.

I am convinced, Mr. Chairman, that we can and that we should pass a good tax reform bill this year. The definition of "good" obviously can be subjective. But I think we can, if we put our mind to it, bring about a fundamental overhaul of our tax system and enhance the prospects for fairness and simplicity, as well as for economic expansion, which really is essential to any deficit reduction package.

It ought to be obvious to all of us we cannot shrink our way out of the deficit; regardless of whether or not growth alone can cure the deficit, we do know one thing, Mr. Chairman—without economic growth and without bringing down high rates of unemployment, there is no prospect in anybody's scenario for even getting close to a manageable level of deficit throughout this decade.

The proponents of tax reform—Senators Bradley and Kasten; Congressman Gephardt and myself and others in the House; Treasury Secretary Baker; Chief of Staff Don Regan, and the President, ultimately—have already begun working, as have your own committee and the Senate Finance Committee, toward achieving what I call a good consensus tax reform bill that would be acceptable on both sides of the political aisle. That is good news for the American people—particularly good news, I think, for the people that I represent in western New York, who are among the highest taxed working men and women in the United States, considering the Federal Tax Code and the New York State taxes as well as the payroll tax.

As I have said many times, the points on which we agree are more important than the points upon which we disagree. All of us, I think, can basically agree on four main principles.

First, tax reform should be revenue neutral in a static sense—and I emphasize the word static, because there are profoundly significant behavioral changes that take place when you shift marginal tax rates either up or down. But in a static sense, we would like to be or remain revenue neutral.

Second, we all agree we should not shift the tax burden significantly among the income classes. We want to maintain the relative progressivity of the burden among income classes.

Third, tax reform should increase economic incentives and efficiency.

Finally, and above everything else, it seems to me, Mr. Chairman, tax reform should encourage economic growth and the goal of full employment for our Nation's work force.

Yet, within this broad agreement on the principles of tax reform, there can be surprising differences in philosophy.

Now that it is clear that there will be tax reform, I think it is increasingly appropriate to focus on some of the differences—constructively, in discussions in this committee and the national debate, so that we can come up with the best consensus bill.

The purpose of my testimony, Mr. Chairman, is to outline the philosophy behind Kemp-Kasten and some of its advantages for the economy and the American family.

All of the tax reform plans, Mr. Chairman, lower the tax rates and simplify the code. But there are a couple of distinguishing characteristics of the Kemp-Kasten "fair and simple tax" [FAST].

First of all, the Kemp-Kasten bill looks at the total tax rate which results from all Government policies, not just the Federal income tax. It is often pointed out that a pure flat income tax rate would be unfair, because it would shift the tax burden downward. But when you think about it, the real problem with a pure flat tax rate is not that it isn't fair, but that it is not flat—the Social Security payroll tax is added on top of the income tax, so that a flat income tax rate means a two-step regressive total tax rate on American working men and women. The payroll tax, as you know, starts on the first dollar of wages, but stops at about $40,000. In addition, high marginal tax rates are imposed, especially on low incomes, by means-testing of transfer payments such as welfare, the earned income tax credit, and even certain rules for Social Security benefits.

When a person who has to give up 50 cents in benefits for every dollar of extra income that he or she earns it amounts to a 50-percent marginal tax rate.

So our plan, Mr. Chairman, tries to look at the total marginal tax rate from all these sources, because that is the tax rate that affects people's decisions to work or save, invest, or be productive.

Second, the Kemp-Kasten bill is very "pro-family." In many important respects, the Kemp-Kasten bill was guided by asking how tax reform would affect the traditional family of modest means trying to raise children in today's economic environment. We also have special provisions favorable to senior citizens, the working poor, single men and women, and two-earner couples; after all, a family does not stop being a family when the children grow up or the parents grow old. But our bill is based on the idea that the family, and not the individual considered in the abstract, is the basic unit of our society.

Over the years, Mr. Chairman, we have instituted all kinds of tax loopholes to protect various groups from rising tax rates, but not the traditional American family.

Back in 1948, the personal exemption was $600; in constant dollars it has shrunk to $237, or to less than two-fifths of its value almost 40 years ago.

From both points of view—marginal tax rates and the family—three of the Kemp-Kasten features are especially important. First, there is a flat 24-percent marginal tax rate on taxable income. Second, there is a new exclusion: In general, people can exclude 20 percent of their wages under Kemp-Kasten in salaries up to the amount that they pay in the Social Security tax. This exclusion is phased out by adding back 20 percent of income in excess of the maximum Social Security wage base, or above about $40,000. Third, we double the personal exemption to $2,000 for each taxpayer, spouse, and dependent. We also retain the current deductions for mortgage interest, real property taxes, charitable contributions, and major—or catastrophic—medical expenses, as well as the tax deferral of all kinds of retirement savings. We also retain the exclusion for employer-provided health and life insurance benefits; many of the other tax preferences in the Tax Code are eliminated. The Tax Code is indexed for inflation.

Let me summarize the advantages. This approach has several major advantages over retaining progressive income tax rates. First, it allows for a much higher tax-free income threshold for the working poor than the other tax reform plans without the cost.

Second, it also allows a lower marginal tax rate at the top.

Third, it substantially removes the unequal tax rates on labor and capital income, and results in a virtually flat combined Federal income and payroll tax rate.

Fourth and finally, it avoids shifting the tax burden as a pure flat income tax rate would do.

Let me briefly discuss the advantages, Mr. Chairman. For many years the taxpayers in upper brackets faced a higher tax rate on investment than on wage income or employment income. This distinction was removed in the 1981 tax bill. However, there still exists a distinction between labor and capital income at the middle- and lower-income levels. The tax rate on workers is higher than the tax rate on savers. This is because the payroll tax is added on top of the personal income tax rate for labor income, but not for capital income. For example, in 1986, a nonitemizing single taxpaying man or woman earning $35,000 would pay a marginal tax rate of 34 percent under the current law, 26 percent under Bradley-Gephardt, and 25 percent under the Treasury plan, on capital income; but 41 percent under current law, 33 percent under Bradley-Gephardt, and 32 percent under the Treasury plan on labor income, or income from wages.

Under the Kemp-Kasten bill, Mr. Chairman, because our unique wage exclusion would offset the payroll tax, the same taxpayer would pay 24 percent on income from capital and 26 percent on income from wages—about the same.

Because the payroll tax stops at $40,000, there are regressive and irregular total Federal tax rates on wages and salaries above the income tax threshold under current law and the other tax reform plans. But under Kemp-Kasten, the income and payroll tax rates are coordinated so that the tax rate starts at 26 percent for labor income, 24 percent for capital income, and ends at 28 percent for both.

Let me discuss for a moment the working poor. Right now, a family living in poverty pays a very stiff, high tax rate of Federal income taxes. That is, the poverty level in 1985 is over $11,000 for a family of four, while the income tax threshold for a family of four is $9,436. Because of inflationary bracket creep, low-income families, who used to be exempt from income taxes, have been swept onto the tax rolls by inflation. In many cases, the disposable income obtainable through transfer payments for not working is almost as great or even greater than the after-tax wages at a comparable level of income.

This is what some social scientists and economists call "the poverty trap." Indeed, Mr. Chairman, in some counties of the United States, a family must earn $16,000 in pretax income to get the equivalent of an $8,000 or $9,000 nontaxable transfer payment for not working. Some of my friends on the right would like to tax transfer payments in order to reduce their relative attractiveness.

It seems to me that instead we should be cutting the tax rate for the poverty level family, or the "working poor" up to 130 percent of the poverty line, to create that incentive.

The Kemp-Kasten bill addresses this problem by dramatically raising the tax-free threshold of income; for example, Mr. Chairman, the income tax threshold for a family of four is $11,800 under the Treasury plan, and $11,500 under Bradley-Gephardt, under Kemp-Kasten, a family of four would not pay any Federal income tax on the first $14,125 of income.

This removes about 1.5 million of the lowest income taxpayers from the tax rolls, which I think is consistent with what this country did in the past, for low-income workers, though as I said this progress has been reversed by the impact of inflation on the steeply progressive income tax system.

We would also modify the earned income tax credit, Mr. Chairman, to reduce the high effective marginal tax rates on low-income working Americans. The Kemp-Kasten bill would coordinate the earned income tax credit and the normal income tax threshold to cut the Federal marginal income tax rate on working poor from about 26 or 27 to 19 percent, or about 25 percent below current law and the other tax reform plans.

Besides having the highest tax-free level of income at the bottom, the Kemp-Kasten bill has the lowest marginal tax rate at the top. This is because with the progressive tax rate, not only those with modest income, but also the very highest income taxpayers begin paying at only 11 percent under current law, 14 percent under Bradley-Gephardt, or 15 percent under the Treasury.

This loses a lot of revenue, Mr. Chairman. It involves a $3,000 or $4,000 tax cut on the first $30,000 or $40,000 of a high income taxpayer's taxable income. So to make up for this revenue loss, other plans must either have a significantly higher top marginal tax rate, such as Treasury, or else significantly reduce the value of allowable tax deductions such as under the Bradley-Gephardt bill.

Under the Kemp-Kasten bill, Mr. Chairman, a high-income taxpayer receives no positive benefit from that disappearing exclusion—which, as I said, starts disappearing above $40,000—and therefore, in effect, pays a flat 24 percent rate from the first taxable dollar. This allows us to bring the top rates down without the revenue loss.

Families with children. If the personal exemption had been indexed for inflation since 1948, it would have to be more than $2,500 today. Instead, Mr. Chairman, as you know, it is only $1,040. However, the value of the personal exemption depends not only on its size, but also on the nature of its deductibility.

For example, under current law, the same $1,000 exemption under current law is worth $114 in the bottom tax bracket, but $520 in the top tax bracket. Bradley-Gephardt reduces the exemption for dependent children from $1,040 in 1985 to $1,000 in 1986. The exemption is worth $140 per child for all taxpaying families, because the Bradley-Gephardt bill limits the value of most deductions to only 14 cents on a dollar.

The personal exemption is $2,000 and indexed for inflation under Kemp-Kasten and the Treasury plan, but the effect is different because of the different rate structures.

Under Treasury's plan, with rates of 15, 25, and 35 percent, the value of each child exemption is $300 in the bottom bracket, but $700 in the top bracket. Under Kemp-Kasten, all deductions, exclusions, exemptions, et cetera, are worth 24 cents on the dollar, because of the flat rate on taxable income. Therefore, the value of each child exemption for a low-income family more than quadruples, Mr. Chairman, from $114 to almost $500 per year. At high incomes, the value of the exemption remains about the same: $480 compared with $520 under current law. So the increased value of the child exemption under Kemp-Kasten is concentrated at the middle- and low-income level. I think this is another reason why the top marginal tax rates can be lower under Kemp-Kasten than under the Treasury plan, although both raise about the same revenue from upper-income taxpayers.

Next, homeowners. Kemp-Kasten reduces the cost of homeownership for families earning near or less than the median income. Our bill retains the deduction for mortgage interest and real property taxes. Like the personal exemption, the value of these deductions is increased at moderate and lower incomes, though reduced in high incomes. According to the National Association of Home Builders, Kemp-Kasten would reduce the cost of homeownership by 3 percent for a typical family earning $20,000 a year, while the Treasury bill and the Bradley-Gephardt plan would increase the cost by 6 percent and 10 percent, respectively.

Beyond encouraging home ownership, the Kemp-Kasten bill retains the deduction for real property taxes, because the property tax, which represents over 40 percent of deductible State and local taxes, is almost always devoted to paying for local education. And we allow the deduction for interest on education loans without limit.

Another important difference is that Kemp-Kasten preserves the exclusion for employer-paid health and life insurance, whereas the Bradley-Gephardt bill taxes both and the Treasury plan taxes life insurance and caps the exclusion for health insurance. We think these costs could be viewed as depreciation allowances for human capital and believe that private rather than public insurance of risk should be encouraged in America wherever possible.

In conclusion, Mr. Chairman, these are only a few advantages of the Kemp-Kasten approach. Several more of them are described in greater detail in my written testimony, which I have submitted for the record. But the time has come for a comprehensive reform of the Federal income tax, as many people agree. We need it in the interest of fairness and simplicity and, especially in the interests of economic expansion and growth.

I believe there will soon be a bill, Mr. Chairman, representing a consensus of the best features of the tax reform plans now on the table. I urge that the committee and other interested parties closely examine the features in Kemp-Kasten I have discussed and some of its advantages for economic growth, families with children, working men and women, the working poor, homeowners, and others. This is where we must begin and end our discussion of tax reform—with the American family, whose effort, thrift and initiative are the mainspring of our progress as a nation.

The proper measure of tax reform is how well it helps the American family in their daily lives, to fulfill their hopes and dreams through their own efforts.

I look forward to working with you, your committee, and other interested parties to meet these important challenges, and thank you for helping to expand this debate on fundamental tax reform for 1985.

[The prepared statement follows:]

STATEMENT OF HON. JACK F. KEMP, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. Chairman and members of the Ways and Means Committee, I am grateful for this opportunity to testify in favor of comprehensive federal income tax reform.

Mr Chairman, until recently the main question about tax reform was whether we would have it at all. But now it is clear, even to opponents of tax reform, that there is a broad, bipartisan consensus to lower tax rates and simplify the tax code. I am convinced that Congress can, must, and will pass a good tax reform bill this year. The proponents of tax reform—Senators Bradley and Kasten, Congressman Gephardt and myself, the Treasury—have already begun working, as has this committee and the Senate Finance Committee, to achieve a good consensus tax reform bill.

This remarkable consensus has been made possible by the unshakable resolve of tax-reform advocates, on both sides of the aisle, not to split to the tax reform posse before we got into town. As we have said many times, the points on which we agree are more important than the points on which we disagree. All of us can agree on four main principles: tax reform should be revenue-neutral, it should not shift the tax burden among income classes, it should increase economic incentives and efficiency, and above all, tax reform should encourage economic growth.

Now, that it is clear that there will be tax reform, it is appropriate to focus on the specific details that will make for the best consensus bill.

In the world of tax economists, there are two competing consistent theories of tax reform—the comprehensive income tax, and the comsumption tax. Yet of the three major tax reform proposals on the table—Bradley-Gephardt, Kemp-Kasten, and the Treasury plan—none is either a pure flat income tax or a pure consumption tax.

The reason is that both the pure flat income tax and the pure flat consumption tax violate some of the objectives I mentioned earlier. Briefly, a pure flat-rate comprehensive income tax, if it is revenue neutral, tends to shift the tax burden from the top to the bottom of the income scale; it can also have even more of a bias against saving than current law. A pure consumption tax, which defers the tax on investment income, has an even worse distributional problem because so much saving is done by upper income taxpayers. And a consumption tax tends to discriminate against certain taxpayers, such as families with children, who must consume more than other taxpayers with an equal income.

In order to overcome some of these difficulties, each of the three major tax reform plans is a hybird of the two "pure" approaches. But each has its own unique mixture, and within the broad political agreement on principles of tax reform, there can be surprising differences in philosophy. The purpose of my testimony today is to outline the philosophy behind Kemp-Kasten and to outline some of its advantages for American families.

KEMP-KASTEN: GENERAL OUTLINES

All of the tax reform plans lower tax rates and simplify the tax code. But there are distinguishing characteristics of the Kemp-Kasten "Fair and Simple Tax" (H.R. 777, S. 325).

First, Kemp-Kasten has given more attention to the total tax rates which result from government policies, including but not limited to the federal income tax. It's the total tax rate that affects people's decisions to work, save, invest, and so on. When you think about it, the real problem with a pure flat-rate tax is not that it isn't fair, but that it isn't flat. The Social Security payroll tax is added on top of the income tax, so that a flat income tax rate means a regressive total tax rate: the payroll tax starts on the first dollars of wages but stops at about $40,000. In addition, marginal tax rates are imposed by means-tested transfer payments, such as welfare benefits, the earned income tax credit, and even certain rules for Social Security benefits. When a person has to give up 50 cents in benefits for every extra dollar of income, it amounts to a 50% marginal tax rate. Our plan looks at the total marginal tax rate from all these sources whenever possible.

Second, Kemp-Kasten is a pro-family tax reform bill. In fact, it is the most favorable overall in its treatment of what might be called investment in human capital. Over the years we have put in all kinds of tax loopholes to protect various groups from rising tax rates—but not the traditional family. Back in 1948, the personal exemption was $600; in constant dollars, it has shrunk to only $137, or to less than one-quarter of its value almost 40 years ago. Mr. Chairman, we don't believe children should be treated for tax purposes like so many consumer durables. They shouldn't be taxed like refrigerators and sailboats. They are our greatest investment.

In many important respects, Kemp-Kasten was guided by asking how tax reform would affect the traditional family of modest means trying to raise children. We also have special provisions favorable to senior citizens, the working poor, single people and two-earner couples; after all, a family doesn't stop being a family when the children grow up and the parents grow old. But our bill is based on the idea that the family, not the individual considered in the abstract, is the basic unit of our society.

From both points of view, three of Kemp-Kasten's features are especially important:

First, there is a flat 24% tax rate on taxable income.

Second, there is a new exclusion: in general, people can exclude 20% of their wages and salaries up to the amount on which they pay Social Security tax. The exclusion is phased out by adding back 20% of income in excess of the maximum Social Security wage base.

Third, we double the personal exemption to $2,000 for each taxpayer, spouse, dependent (as well as the extra exemption for the elderly, blind and disabled).

We also retain the current deductions for mortgage interest, real property taxes, charitable contributions, and catastrophic medical expenses, as well as the tax deferral of all kinds of retirement saving. We also retain the exclusion for employer-provided health and life insurance. Many of the other tax preferences in the tax code are eliminated. The exemptions and zero bracket amounts are indexed for inflation.

Summary of advantages.—This approach has several major advantages over progressive income tax rates. It allows a much higher tax-free income threshold than the other tax reform plans without greater cost. It also allows a lower marginal tax rate at the top. It substantially removes the unequal tax rates on labor and capital income, and results in a virtually flat combined income and payroll tax rate. Finally, it avoids shifting the tax burden like a pure flat income tax rate.

Let me explain these advantages by considering their effect on various taxpayers.

Wage-earners.—For many years upper-bracket taxpayers faced a higher tax rate on investment than on employment income. This distinction was removed in the 1981 tax bill. However, there still exists a distinction between labor and capital income at middle and lower incomes. Under current law (and the other tax reform plans) the payroll tax is added on top of the personal income tax rate for labor income, but not for capital income. Therefore the tax rate on workers is higher than the tax rate on savers. This is true under current law and under all tax reform plans other than Kemp-Kasten.

For example, in 1986 a non-itemizing single taxpayer earning $35,000 would pay marginal tax rates of 34% under current law, 26% under Bradley-Gephardt, and 25% under the Treasury plan, on capital income—but 41% under current law, 33% under Bradley-Gephardt, and 32% under the Treasury plan on *labor* income. But under Kemp-Kasten, because the wage exclusion offsets most of the payroll tax, the same taxpayer would pay 24% on capital income and 26% on labor income—almost the same. (Graph 1)

For a similar reason, there are regressive and irregular federal tax rates on wages and salaries. Since the payroll tax base stops at about $40,000, the marginal tax rate on labor income can be higher at a lower than a higher income level, under both current law and the other tax reform plans. Viewed by income level, the combined marginal tax rate structure above the income tax threshold behaves as follows. Current law: the tax rate starts at 18%, rises to 41%, falls to 34%, then rises to 50%. Bradley-Gephardt: the tax rate starts at 21%, rises to 37%, then falls to 30%. Treasury plan: the tax rate starts at 22%, rises to 42%, then falls to 35%. Under Kemp-Kasten, the income and payroll tax rates are co-ordinated, so that the tax rate starts at 26% for labor income, 24% for capital income, and ends at 28% for both.

The working poor.—Right now, families living in poverty pay rather stiff rates of federal income tax. The poverty level in 1985 is $11,101 for a family of four (it will probably be more than $11,500 next year), while the income tax threshold for a family of four is $7,700 (or $9,436 including the earned income tax credit). Much of the worst impact of inflationary bracket creep has been felt by low-income families, who used to be exempt from income tax but have been swept on to the tax rolls by inflation. The tax disincentives are compounded because in many cases the disposable income obtainable through transfer payments for not working is almost as great as or even greater than aftertax wages at a comparable income. This is the famous "poverty trap."

Kemp-Kasten addresses this problem in several ways. One way is significantly to raise the tax-free threshold of income. The income tax threshold for a family of four is raised to $11,800 under the Treasury plan, and $11,500 under Bradley-Gephardt, or just about to next year's poverty line. But under Kemp-Kasten the tax-free level of income for a family of four is raised to $14,125 (Graph 2). For a single taxpayer, the income tax threshold is $5,750 under Kemp-Kasten, compared with $4,800 under the Treasury plan, $4,600 under Bradley-Gephardt, and $3,430 under current law. Under Kemp-Kasten, the income tax threshold for a retired couple is raised from $7,700 to $14,125, and for a retired single person from $4,470 to $8,250. The income tax threshold for a single parent with two dependents is increased from $8,375 to $10,750. This removes about 1.5 million of the lowest-income taxpayers from the tax rolls, and indexing will keep them off the rolls for as long as they are poor.

Another Kemp-Kasten change which cuts high effective marginal tax rates at low incomes, is to modify the earned income credit. Under current law, the earned income credit is 11% of earned income up to $5,000. The maximum credit of $550 is phased out by reducing the credit by 12 2/9% of income in excess of $6,500. This makes the credit disappear at $11,000. Phasing out the credit adds a marginal tax rate of 12 2/9% to the usual tax rate; and since the bottom income tax brackets overlap the phaseout range of the earned income tax credit, this can result in fairly high effective marginal tax rates at low incomes, under current law and under the other tax reform plans. For example, a single head of household earning $10,000 with one dependent faces a marginal income tax rate of 26% under current law and under Bradley-Gephardt, and 27% under the Treasury plan, plus the 7% payroll tax rate and the 50%-75% effective marginal tax rates from foregoing transfer payments.

Kemp-Kasten reduces these effective marginal income tax rates by co-ordinating the earned income credit and the normal income tax thresholds. We increase the credit from 11% to 15%, thereby increasing the maximum credit from $550 at $5,000 to $600 at $4,000. But we phase out the credit completely at $8,000—just below the $8,250 tax threshold for a single head of household—in order to end the overlapping which causes the spike in effective marginal tax rates. This reduces effective federal marginal income tax rates on the working poor by about 25% below current law and the other tax reform plans (Graph 3). Kemp-Kasten also indexes the earned income credit for inflation, for the first time.

Important as the "poverty trap" is, cutting high effective marginal tax rates alone will not magically cure poverty. The more we understand about the causes of poverty, the more we are drawn to the conclusion that it has at least as much to do with the stability of families as with after-tax income. While this question goes far beyond the realm of tax policy, I believe that the "pro-family" aspects of Kemp-Kasten, which I will describe in a moment, should be considered as an integral part of its antipoverty strategy.

Lowest top marginal tax rate.—Besides having the highest tax-free level of income at the bottom, Kemp-Kasten has the lowest marginal tax rate at the top. Both are results of the flat rate and disappearing exclusion.

With progressive tax rates, not only those with modest incomes, but also the very highest-income taxpayers, begin paying tax at only 11% (current law), 14% (Bradley-Gephardt) or 15% (Treasury). Because this involves a $3,000 or $4,000 tax cut on the first $30,000 or $40,000 of a high-income taxpayer's taxable income, the other plans must have a significantly higher top marginal tax rate (Treasury), or else significantly reduce the value of allowable tax deductions (Bradley-Gephardt), to raise a given amount of revenue.

Under Kemp-Kasten, a high-income taxpayer receives no positive benefit from the "disappearing" exclusion, and therefore in effect pays a flat 24% rate from the first taxable dollar. This permits a lower (28%) marginal tax rate on high-income taxpayers for a given level of tax revenue. Kemp-Kasten raises about the same revenue in static terms from taxpayers over $100,000 as the Treasury plan, despite a much lower marginal tax rate.

Families with children.—According to former Treasury economist Eugene Steuerle, the drastic erosion of the personal exemption by inflation has caused taxes to rise almost twice as fast for families with children as for other taxpayers since the Second World War. If the personal exemption had been indexed for inflation since 1948, it would have to be more than $2,500 today. Instead, it is only $1,040.

However, the value of the personal exemption depends not only on its size, but also on the nature of its deductibility. For example, the same $1,040 exemption under current law is worth $114 in the bottom tax bracket, but $520 in the top tax bracket.

Bradley-Gephardt increases the exemption for adults to $1,600, but reduces the exemption for dependent children from $1,040 in 1985 to $1,000 in 1986. Because of the higher bottom tax rate, the value of the exemption for each child rises a bit from $114 to $140 a year, though Bradley-Gephardt repeals inflation-indexing. Since the Bradley-Gephardt plan allows the exemption only against the 14% bottom tax rate, the exemption is worth $140 for all taxpayers, including those in the 26% and 30% tax brackets. This represents a reduction of the tax value for the exemption in the top bracket from $520 to $140.

The personal exemption is worth $2,000 and indexed for inflation under both Kemp-Kasten and the Treasury plan. But because of the different rate structures, the effect of the $2,000 exemption is different under the Treasury plan than under Kemp-Kasten.

Under the Treasury plan, with tax rates of 15%, 25% and 35%, the value of each child exemption rises from $114 to $300 in the bottom tax bracket, but from $520 to $700 in the top tax bracket. Under Kemp-Kasten, all deductions, exclusions, exemptions, etc., are worth 24 cents on a dollar. Therefore, the value of each child exemption for a low-income family more than quadruples, from $114 to $480 a year. At high incomes the value of the exemption remains about the same, $480 compared with $520 under current law (Graph 4). The increased value of the child exemption under Kemp-Kasten is concentrated at middle and low incomes. Because the personal exemption is such a large revenue item, this is another reason why the top marginal tax rate can be lower under Kemp-Kasten than under the Treasury plan.

Homeownership.—The Kemp-Kasten philosophy is unabashed in believing that home-ownership ought to be encouraged. One of the interesting features of Kemp-Kasten is that it reduces the cost of homeownership for typical families earning near or less than the median income.

Our bill retains the deductions for mortgage interest and real property taxes. And as with the personal exemption, the value of these deductions is increased at moderate and lower incomes, though reduced at high incomes. The effective marginal tax rate on wages is 19%, because of the exclusion, but deductions are worth the full 24% flat tax rate. According to the National Association of Homebuilders (NAHB), Kemp-Kasten would reduce the cost of homeownership by 3% for a typical family earning $20,000 a year, while the Treasury and Bradley-Gephardt plans would increase the cost by 6% and 10% respectively (Graph 5).

Incidentally, the treatment of homeownership under current law and Kemp-Kasten is essentially similar to its treatment under a consumption tax: families must pay principal out of after-tax income, but the imputed rent is not taxed. I do not believe that tax theory requires us to punish home-ownership.

Investment in human capital.—Kemp-Kasten differs significantly from the other tax reform plans in its approach to investment in human capital. Progressivity plays a role here as well. With progressive tax rates, tax deferral of retirement savings is normally favorable to capital income because a taxpayer is generally in a lower tax bracket after he retires than when the deduction is made. Progressivity has the opposite effect, though, for the few deductions allowed for investment in human capital, because a person is generally in a low tax bracket when the investment is made, but the increased value of personal services push the taxpayer into a higher tax bracket. The Kemp-Kasten treatment of deductions is therefore more favorable to investment in human capital than either current law, a progressive consumption tax, or the other tax reform plans.

Beyond encouraging homeownership, Kemp-Kasten retains the deduction for real property taxes because the property tax is almost always devoted to local education. Retaining the deduction is another way off offsetting the bias against investment in human capital. And we allow the deduction for interest on education loans without limit.

Another important difference is that Kemp-Kasten preserves the exclusions for employer-paid health and life insurance. Bradley-Gephardt taxes both employer-paid health and life insurance; the Treasury plan taxes group term life insurance premiums and caps the exclusions for health insurance. These costs could be viewed as depreciation allowances for human capital. We believe that private rather than public insurance of risk should be encouraged where possible. When the private sector is discouraged from providing for such basic needs, the usual result is to increase the pressure for public provision.

More family issues.—Kemp-Kasten seeks to equalize the tax treatment among families in several ways. Both Bradley-Gephardt and the Treasury plan repeal the child care credit and replace it with a deduction for child care expenses, which generally helps only two-earner families with children below school age. Kemp-Kasten repeals the credit and devotes the extra revenue, in effect, to helping all families with children by increasing the personal exemption. Compared with current law, this helps one-earner families with children more than two-earner families; but in general the Kemp-Kasten treatment is absolutely more favorable for all low- and moderate-income families than either Bradley-Gephardt or the Treasury plan. For example, a family of four earning $15,000, with the second spouse earning a third of the income and child care expenses totaling 10% of the family's total income, pays a federal income tax in 1986 of $393 under current law, $475 under Bradley-Gephardt, $419 under the Treasury plan, and $168 under Kemp-Kasten. With only one earner and no child care expenses, the federal tax is $868 under current law, $532 under Bradley-Gephardt, $480 under the Treasury plan, and $168 under Kemp-Kasten.

In this way, Kemp-Kasten equalizes the treatment of families with children, regardless of their parents' employment status. Any other approach seems to imply that the effort of the parent who stays at home to care for the children is worth less than if he or she worked outside the home. It does not seem fair to recognize the expense of earning a second income, but ignore the cost of giving up a second career, which often goes with the decision of a spouse to remain at home to raise the children.

At the same time, Kemp-Kasten removes a bias against two-earner couples, which exists under current law and the other major tax reform plans. A two-earner family with combined wages in excess of the Social Security payroll tax base pays a higher Social Security payroll tax and therefore a higher combined marginal tax rate than other taxpayers on the same income. Under Kemp-Kasten, two-earner couples may figure out their 20% wage exclusions separately and add the two, if this results in a larger total exclusion. This offsets 5 of the 7 percentage-point increase in the combined marginal tax rate that occurs under current law and the other tax reform plans. In a sense, then, the Kemp/Kasten wage exclusion acts like a second-earner deduction for married couples.

Senior citizens.—Kemp-Kasten has a number of features which help senior citizens.

First, Kemp/Kasten increases the personal exemptions for each senior citizen from $2,080 to $4,000 (which amount is indexed for inflation). (Bradley-Gephardt increases the total exemptions to $2,600, while the Treasury leaves the exemption at $2,000, plus a special credit at low incomes.)

Second, the special rule allowing the 20% exclusion to apply to all income up to $10,000 (single) or $15,000 (joint) is designed to protect senior citizens who live mostly from investment income rather than from wages (which benefit from the wage exclusion). These amounts are indexed for inflation.

Together, these provisions substantially increase the income tax threshold for senior citizens—from $7,700 to $14,125 for a retired couple, and from $4,470 to $8,250 for a retired single person.

In addition, reducing the top income tax rate from 50% to 28%, and continuing the exclusion for income from general-obligation municipal bonds, is beneficial to people whose income is primarily from investment of lifetime savings.

The deductibility of property taxes is also especially important for senior citizens. For retired homeowners who have paid off the mortgage, it is often the largest itemized deduction. And because the property tax is a tax on capital rather than on income or consumption, its incidence is greatly magnified. Assuming a 4% real rate of return, a 2% property tax is equivalent to a 50% marginal income tax rate. Under current law, federal deductibility can mean the difference between a 25% and a 50% income-tax-rate-equivalent.

The "96% bracket."—Beyond these general advantages, Kemp-Kasten addresses a number of anomalies in current tax law which affect senior citizens, largely due to the lack of co-ordination between the income tax code and the Social Security system. In general, in Kemp-Kasten we have tried to reduce excessively high marginal income tax rates on senior citizens without changing the basic structure of Social Security.

A combination of tax and benefit provisions can result in what has been called the "96% bracket" for senior citizens, though it can actually exceed 100%. These high tax rates are caused by an interaction of the following provisions:

First, the "retirement test" reduces Social Security benefits by 50 cents for every dollar above $7,320 earned by those between the ages of 65 and 70. This creates, in effect, a 50% marginal tax rate on wages and salaries for Social Security beneficiaries.

Second, the 1983 Social Security amendments effectively increased the federal marginal income tax rate on many senior citizens to at least 150% of the statutory rate. This is because a taxpayer must add 50 cents in benefits to taxtable income for each dollar of income above a certain threshold of redefined adjusted gross income—$25,000 for single taxpayers and $32,000 for married couples—until one-half of benefits are taxed.

Finally, such taxpayers must also pay ordinary federal, state and local income and payroll taxes.

For example, a retired couple with $32,000 in adjusted gross income and $12,000 in Social Security benefits would have been in the 25 percent federal income tax bracket in 1984 before the new method of taxing Social Security benefits was enacted. The new method of taxing benefits effectively pushes the family from the 25% into the 42% bracket on investment income, while the retirement test adds another 50% marginal tax rate on wages and salaries. Together with the payroll tax, this results in a 99% effective marginal tax rate on wages.

Kemp-Kasten eliminates the "96% bracket" in the following way:

First, the bill would phase out the retirement test, by cutting the benefit reduction from 50 to 25 cents on a dollar of earnings immediately, and zero benefit reduction after five years.

Second, the bill reduces the marginal taxable amount of Social Security benefits, from 50 to 25 cents per dollar of income in excess of the adjusted income thresholds, though up to half of benefits may still be taxed.

For the retired couple I just mentioned, Kemp-Kasten's provisions reduce the effective marginal tax rate due to the retirement test from 50% to 25%, then to 0%. The effective marginal federal income tax rate is cut from 42% to 24%, both because of marginal tax rate reduction and because of the new method of taxing Social Security benefits. The combined effective marginal federal tax rate on this family's wages is ultimately cut from 99% under current law to 32% under Kemp-Kasten.

INVESTMENT INCENTIVES

Capital gains.—The treatment of capital gains is especially important for the encouragement of initiative and risk-taking, which are indispensable to a dynamic economy. The Treasury plan taxes capital gains as ordinary income but indexes the capital basis for inflation. Bradley-Gephardt taxes cpaital gains in full without indexing. The first version of Kemp-Kasten resembled the Treasury treatment, except that we had a 25% instead of a 35% top tax rate on ordinary income and a 10-year transition period during which taxpayers could choose a 25% captial gains exclusion in lieu of indexing.

There are two kinds of investors who must be considered, and no single, simple treatment is likely to make them whole. The typical investor holds an asset for a long period and receives a fairly modest real rate of return; for this investor, indexing of basis is very important to avoid the taxation of capital as income, as was the case throughout the 1970s. However, the entrepreneur and the high-risk venture capitalist typically have a basis in an investment which is very low or even zero, and they seek a high real rate of return as the reward for successfully risking their capital. When a stock goes from 50 cents to 10 dollars, indexing the 50 cents doesn't help much. Taxing the gain as ordinary income would threrfore penalize the risk-taker, especially if the top tax rate rises from 20% to 35% as under the Treasury plan.

We decided in our new bill to offer two permanent options. Under the current version of Kemp-Kasten, in any year, a taxpayer may elect to have his capital gains taxed as ordinary income with indexing, or else forego the indexing and receive a 40% exclusion (or in the case of corporations, a reduced 20% alternative capital gains rate). With the 40% exclusion, the top marginal tax rate on capital gains would effectively be reduced from 20% to about 17% for individuals. I believe this approach is fair both to the ordinary investor and to the entrepreneur or venture capitalist.

Corporate provisions.—For business, all three major tax reform plans lower the corporate tax rate into the low 30's, and repeal the investment tax credit and many other corporate tax preferences. However, both Bradley-Gephardt and the Treausry plan move in the direction of depreciation according to the comprehensive income tax, under which writeoff periods try to approximate the estimated useful lives of assets. This approach has been criticized by some for increasing the cost of capital for new investment, and for increasing the disparities in present values of depreciation allowances between short- and long-lived assets.

On the other hand, current law has been criticized because the combination of the investment tax credit and the Accelerated Cost Recovery System (ACRS) depreciation allowances enacted in 1981, when inflation was expected to continue in double digits, can result in an outright subsidy when the discount rate is low enough—that is, the capital cost can exceed the value of expensing when inflation is low. Yet at higher rates of inflation, capital cost recovery falls short of expensing, by amounts which increase with asset class life. Part of this disparity comes from the fact that not all kinds of investment qualify for the investment tax credit. And because both ACRS and the investment tax credit are heavily "frontloaded," current law has also been criticized for lending itself to tax shelters based on up-front cash flow rather than economic value.

The first version of Kemp-Kasten kept the current-law Accelerated Cost Recovery System (ACRS) depreciation, repealed the investment tax credit and most other corporate tax preferences, and lowered the top corporate tax rate to 30%, with a reduced 15% rate for small business below $50,000. This in itself went a long way toward removing the disparities in effective tax rates across industries and among different kinds of investments, while maintaining incentives for capital formation. However, we found a way to improve upon it.

The new version of the bill cuts the top corporate tax rate from 46% to 35% and modifies the ACRS depreciation allowances into something we call the Neutral Cost Recovery System (NCRS). NCRS is designed to provide the present value of investment expensing without some of its practical problems. We keep the same asset classes as ACRS, but the writeoff period is slightly lengthened and the total writeoff is increased to include inflation indexing and a 3.5% real rate of return.

For example, the ACRS 5-year class, which includes most business machinery, becomes six year, but the total writeoff is increased from 100% of the initial cost to 110% plus indexing. Assuming 5% inflation, on a $1,000 investment a company could therefore write off $1,153 over six years instead of $1,000 over five years. Similarly, the three-year class for vehicles becomes four years and the writeoff increases from 100% to 106% plus indexing; the 18-year class for real estate becomes 25 years and the total writeoff is 148% plus indexing.

In each case the present value of the depreciation allowance is equivalent to expensing, assuming a 3.5% real rate of return on capital, which is approximately the post-war average. Kemp-Kasten therefore removes both the outright subsidy to new investment at low rates of inflation, and the bias against capital investment at high rates of inflation. A study released in the past week by the Institute for Research on the Economics of Taxation (IRET) compared the neutrality of tax treatment of depreciable investment under various tax plans, and concluded: "The inflation-indexed Neutral Cost Recovery System (NCRS) included in the Kemp-Kasten 'FAST' proposal would much more nearly satisfy the inter-asset neutrality criterion, at any rate of inflation, than either RCRS [the Treasury plan] or ACRS-ITC [current law]. It would also effectively eliminate the prevailing income tax bias against investment in durable capital. It is an innovative approach to resolving the problem of the front-loaded ACRS-ITC without the adverse effects on the cost of capital in the RCRS [Treasury proposal]."

Since the writeoffs are strectched out, the plan avoids the up-front revenue costs of pure expensing; in fact, NCRS would raise corporate receipts for several years. Because capital cost recovery under Kemp-Kasten is "backloaded" compared with current law (after the first year, which uses a half-year convention, the writeoffs are straightlined in round percentages), NCRS and the sharply reduced marginal tax rates under Kemp-Kasten reduce the possibilities for tax shelter while increasing after-tax incentives for capital investment. This treatment effectively eliminates the double taxation of corporate income, eliminating the need for integration schemes which add to the complexity of the tax code. Finally, industries which face high effective tax rates under current law because they cannot take advantage of items like the investment tax credit will benefit substantially from the reduced corporate tax rates and increased present value of depreciation for plant.

Small business.—Kemp-Kasten has important features for small business, too. We retain reduced tax rates of 15% up to $50,000, and 25% from $50,000 to $100,000. The Treasury has a flat rate of 33%, and Bradley-Gephardt a flat rate of 30%. (Graph 6) Kemp-Kasten also retains a current-law provision permitting expensing of up to $10,000 of investment per year.

Revenue considerations.—Earlier versions of our bill were estimated by the Joint Committee on Taxation to be revenue-neutral in 1985, and distributionally neutral in all income classes up to $100,000. (There would be static revenue losses—small in dollar amount—of about 10% for the income class in excess of $100,000.) We do not yet have official estimates for our new bill, but anticipate that the results will be similar.

One of the main reasons for tax reform is to change people's incentives, so that they produce, save and invest more than before. As many reports in the past week have demonstrated, based on two straight years of evidence, the 1981 tax-rate reduction has increased the revenues and share of the tax burden paid by upper-income taxpayers. Lowering excessively high marginal tax rates has been followed by dramatic increases in reported taxable income.

For this reason, a well-designed tax reform which was revenue neutral in a static sense would dramatically reduce the deficit. A recent study by the Harris Bank of Chicago reached the following conclusions:

"By 1990 the leading tax reform proposals would enable the economy to produce anywhere from $430 billion to $750 billion (1985 dollars) more output than under the present system. . . . Of the major tax reform proposals, the best overall performance occurs under the Kemp-Kasten plan. . . . Implementing [the Kemp-Kasten] provisions leads to an additional $750 billion in (1985 dollars) of potential output in 1990 over what would be the case under present law. The difference represents more than $5,000 of additional real income per worker in 1990. Beyond 1990 the effect of compounding results in even more dramatic results. . . . This proposal provides the best opportunity of economic stability."

If the Harris Bank study is correct, the additional $750 billion in GNP under Kemp-Kasten would mean more than $140 billion in additional federal revenues and $107 billion in additional state receipts which could be used for better services or further tax-rate reduction.

CONCLUSION

Mr. Chairman, the time has come for a comprehensive reform of the federal income tax. We need such a reform in the interests of fairness, simplicity, and economic growth. I believe there will soon be a bill representing a consensus upon the best features of the tax reform plans now on the table. I would urge, Mr. Chairman, that this committee and other interested parties closely examine the approach we have taken in Kemp-Kasten, and its advantages for families with children, the working poor, homeowners and others. For this is where we must begin and end, Mr. Chairman—with the American families whose effort, thrift and initiative are the mainspring of our progress as a nation. The proper measure of tax reform is how well it helps American families in their daily lives to fulfill their hopes through their own efforts. I look forward to working with you and your committee to meet this challenge.

Thank you.

THE KEMP-KASTEN "FAIR AND SIMPLE TAX" (FAST)

PERSONAL INCOME TAX

After deducting generous personal allowances and employment income exclusion, all taxable income is taxed at a reduced rate of 24%.

Kemp-Kasten eliminates most deductions, credits, exemptions, exclusions except:

Personal allowance

Personal exemption doubled to $2,000 for each taxpayer, spouse, and dependent below age 19; extra $2,000 exemption for elderly, blind and disabled; zero-bracket amounts (standard deduction) of $2,600 single, $2,700 head of household, $3,300 joint; indexes for inflation the personal exemption, zero-bracket amounts, earned income credit.

New exclusion for earned and unearned income

Excludes 20% of gross wage, salary, and self-employment income up to Social Security wage base ($41,700 in 1986, and indexed by law); phased out to result in a maximum effective marginal tax rate of about 28%.

For those with employment income of less than $10,000 (single) or $15,000 (joint return), excludes 20% of any income from taxation, regardless of its source, up to those amounts; this is designed to protect those who live mostly from savings and pension income rather than wages.

Retains deductions for

Charitable contributions; interest on mortgages and loans for education and investments; real property taxes; medical expenses above 10% of adjusted gross income.

Treatment of capital gains and losses

Taxpayers may choose between full taxation of gains, which basis indexed for inflation from date of enactment, or excluding 40% of gains (17% top rate) without indexing; current homeowner's rollover and one-time exclusion is retained; six-month holding period made permanent.

Retains current treatment of

Retirement annuities (IRA's, Keoghs [H.R. 10], Social Security [improved treatment], corporate pensions); military and veterans benefits; employer-provided benefits (such as health, life insurance premiums); foreign source income; earned income credit (slightly modified); general obligation tax-exempt bonds; employee business expenses and moving expenses; ordinary business expenses.

CORPORATE INCOME TAX

Reduced rate of 35% applied to the following tax bases:

Kemp-Kasten eliminates most deductions, credits, exemptions, exclusions except:

Deductions listed above, if applicable, e.g., charitable contributions; ordinary business expenses.

Capital gains treatment: either full taxation with indexing, or a reduced 20% rate without indexing; foreign income tax credit.

Small business provisions: 15% tax rate up to $50,000 taxable income; 25% rate for $50,000 to $100,000 taxable income; expensing for up to $10,000 of business property.

Neutral Cost Recovery System (NCRS): current-law capital cost recovery schedules are modified to provide the economic equivalent of expensing, and indexed for inflation.

EXPLANATION OF THE KEMP-KASTEN WAGE EXCLUSION

Under Kemp-Kasten, taxpayers may generally exclude one-fifth of wages and salaries up to the amount on which they pay Social Security tax. This lowers the effective marginal tax rate from 24% of 19.2% up to the maximum Social Security earnings level. The Social Security wage base is expected to be $41,700 in 1986, which would make the maximum wage exclusion $8,340 in that year. The wage base is already indexed by law to grow with inflation and real average wages.

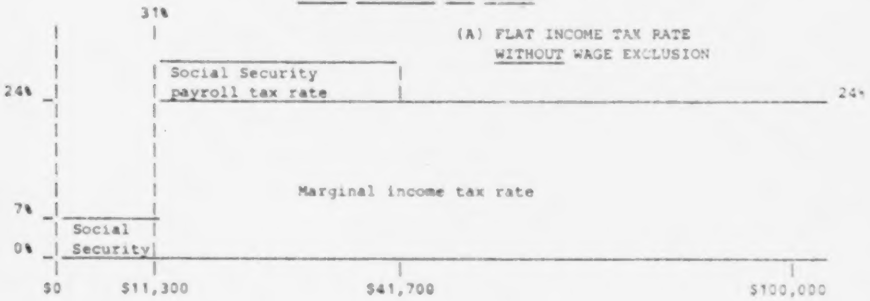
There are two special rules. First, taxpayers with wages and salaries less than $10,000 for single people, or $15,000 for married couples, may exclude 20% of income from any source up to those amounts. Second, two-earner couples with combined wages in excess of the Social Security wage base may exclude 20% of the total amount on which they paid the payroll tax.

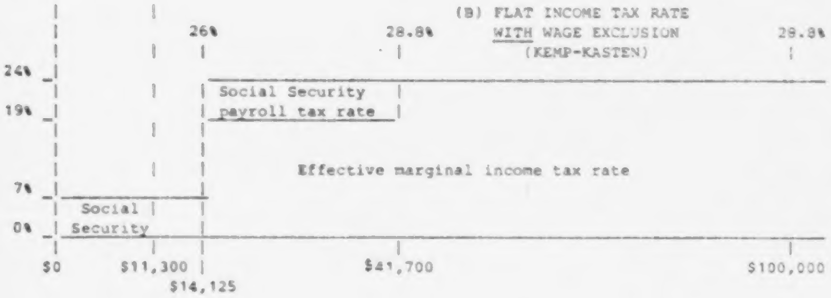
The exclusion figured in this way is phased out at upper incomes by adding back an amount equal to 20% of a taxpayer's income in excess of the Social Security maximum taxable earnings base. The exclusion falls to zero at twice the FICA wage base, or $83,400 in 1986. Just as the exclusion lowers the effective marginal tax rate at lower incomes, phasing it out increases the effective marginal tax rates at higher incomes, from 24% to 28.8%.

(Earlier versions of the bill had a "notch" when the effective marginal tax rate fell from 28% to the flat 25% rate once the wage exclusion was completely phased out. Also, the exclusion for non-wage income was not phased out. In the new bill, the phaseout applies to both labor and capital income, and the marginal tax rate effectively stays at about 28% for all taxpayers above the Social Security wage base.)

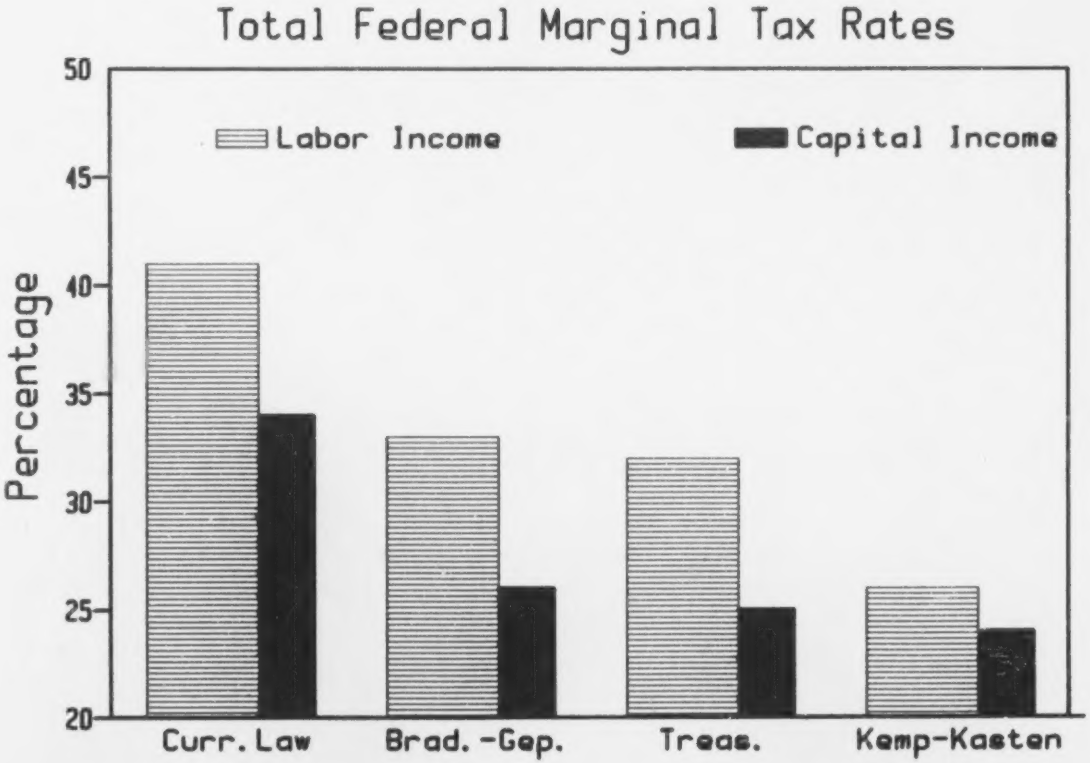
THE EMPLOYMENT INCOME EXCLUSION: A BREAK FOR LOWER AND MIDDLE INCOME WAGE-EARNERS
(Non-itemizing one-earner family of four, 1986)

TOTAL MARGINAL TAX RATES:





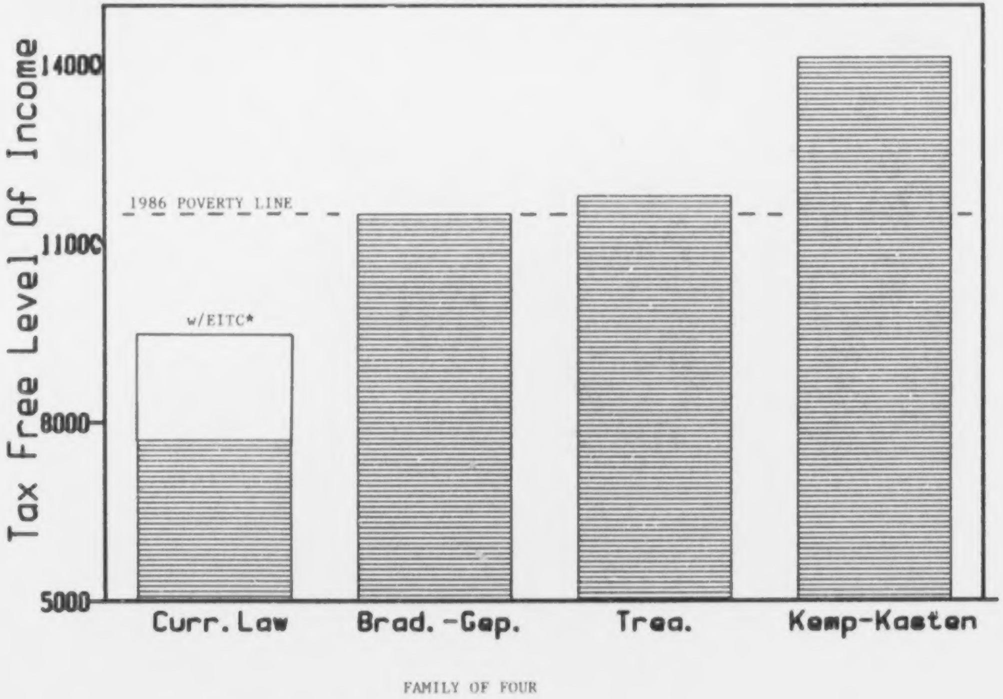
GRAPH 1



(SINGLE TAXPAYER EARNING $35,000, 1986)

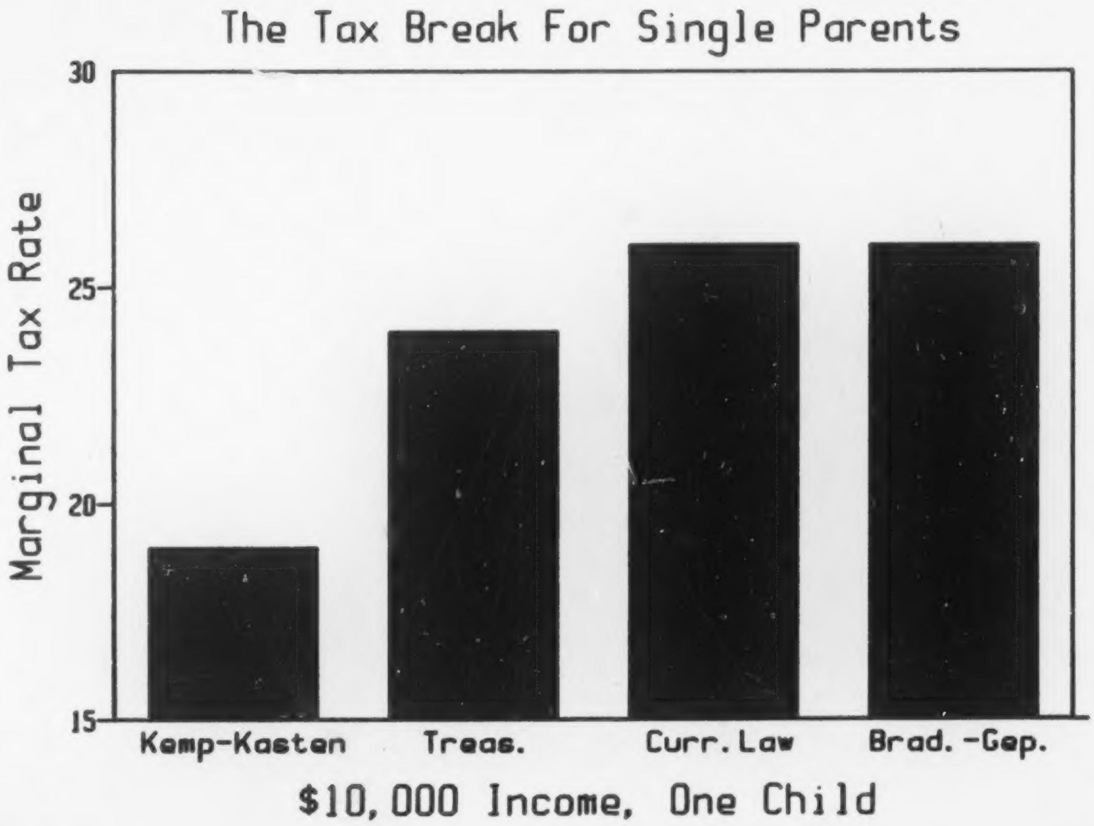
GRAPH 2

Kemp-Kasten: A Tax Break For The Working Poor

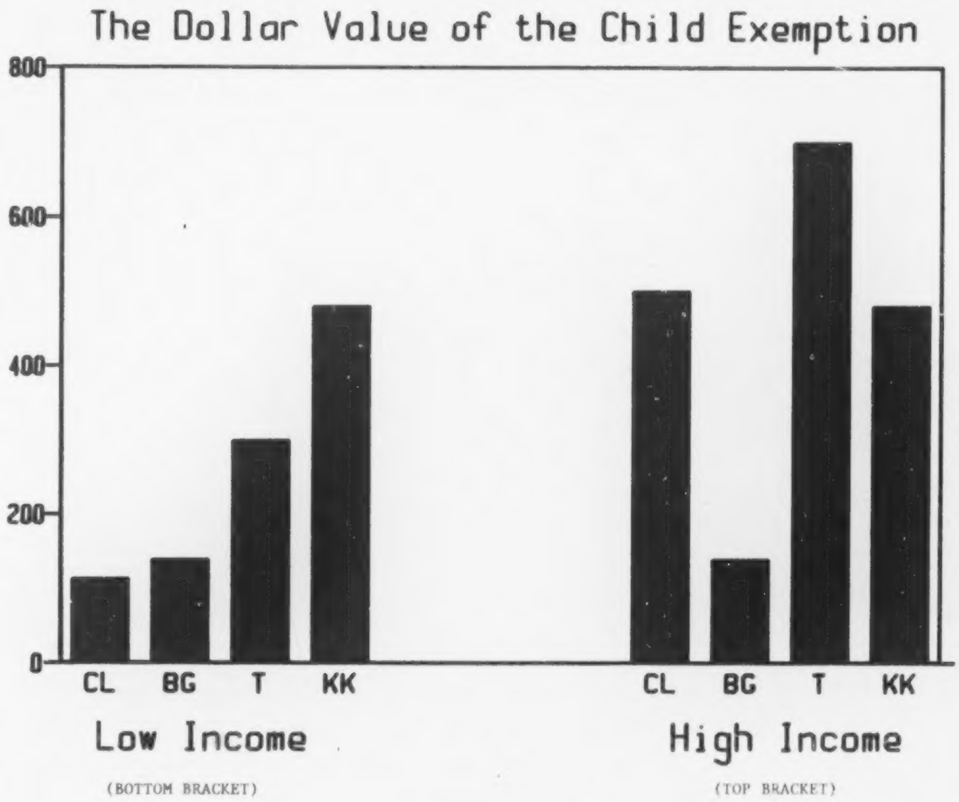


* With earned income tax credit

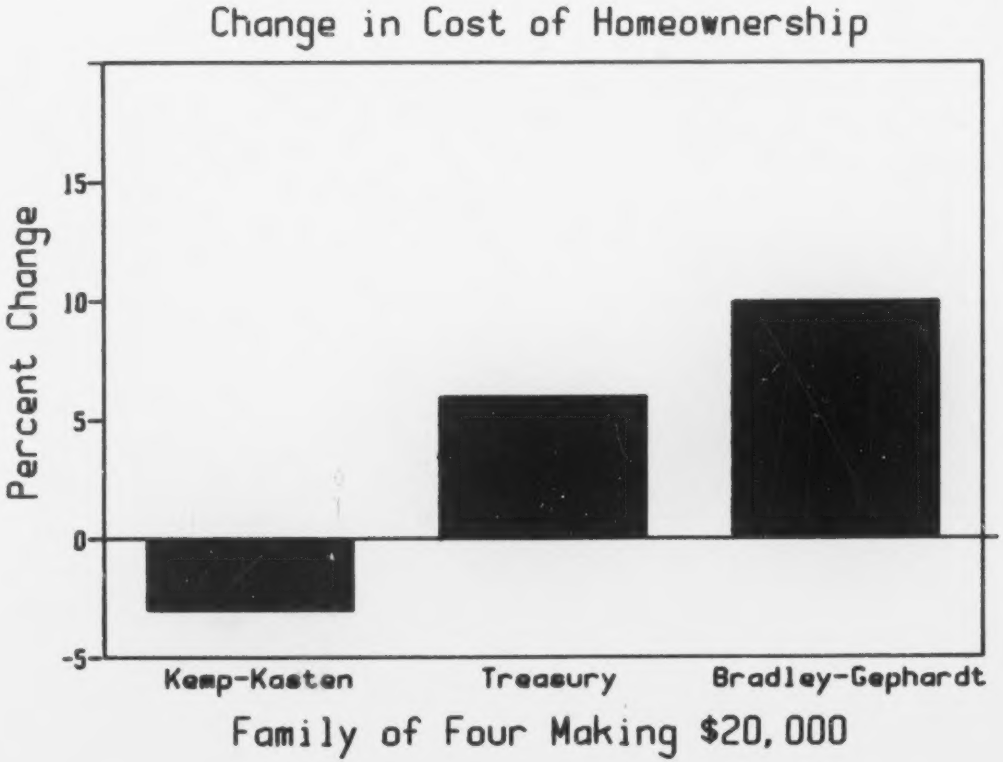
GRAPH 3


The Tax Break For Single Parents
Marginal Tax Rate
30
25
20
15
Kamp-Kasten
Treas.
Curr.Law
Brad.-Gep.
$10,000 Income, One Child

GRAPH 4


The Dollar Value of the Child Exemption
800
600
400
200
0
CL
BG
T
KK
CL
BG
T
KK
Low Income
(BOTTOM BRACKET)
High Income
(TOP BRACKET)

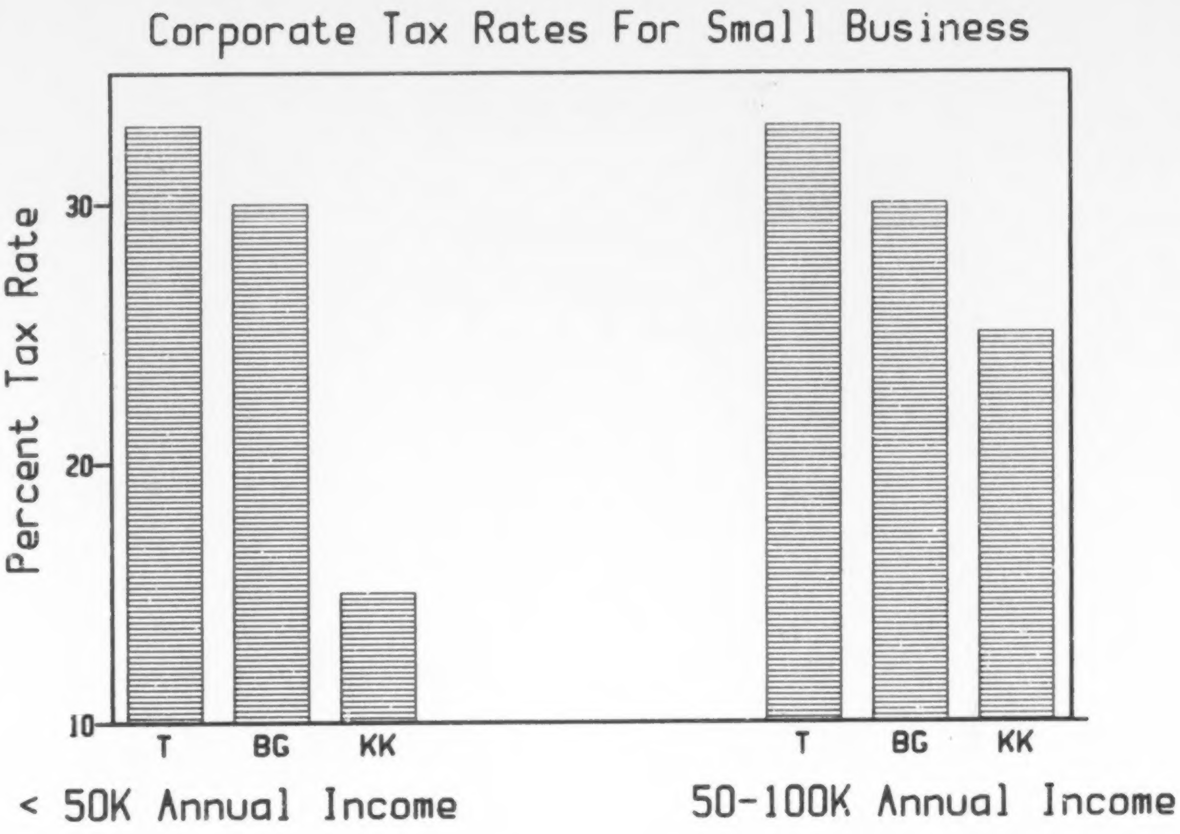
GRAPH 5



Change in Cost of Homeownership

SOURCE: NAHB

GRAPH 6


Corporate Tax Rates For Small Business

THE NEUTRAL COST RECOVERY SYSTEM [NCRS]: CAPITAL COST RECOVERY UNDER KEMP-KASTEN

The Kemp-Kasten "Fair and Simple Tax" (FAST) modifies the current-law Accelerated Cost Recovery System (ACRS) to provide the economic equivalent of investment expensing—the Neutral Cost Recovery System (NCRS).

The ACRS depreciation classes are retained. The depreciation allowances are indexed for inflation. The class lives are slightly lengthened and the total nominal writeoffs are increased to provide the present value of expensing. For example, the 5-year writeoff for machinery is lengthened to 6 years under NCRS, but the total depreciation allowance is increased from 100 to 110 percent of the initial investment (plus inflation-indexing). This is equivalent to expensing at a 3.5% real rate of return, which is slightly above the postwar average. [NCRS is more favorable than ACRS depreciation for real interest rates up to 24% (3-year property) or 48% (5-year property).]

NCRS is neutral with respect to long-lived and short-lived investments, unlike current law. It is also neutral with respect to the relative value of capital assets and consumption goods. And an expensing-equivalent depreciation schedule effectively eliminates the double tax on corporate income.

NCRS avoids a drawback of pure expensing: a large up-front revenue loss which could be recouped only in later years. Though the cost of capital is lower under NCRS than under current-law schedules, NCRS is not "front-loaded" like ACRS, and should raise corporate tax receipts for several years.

Aside from instituting NCRS, Kemp-Kasten repeals most corporate tax preferences, including the investment tax credit, and cuts the top corporate tax rate from 46% to 35%.

AMOUNT OF DEPRECIATION ALLOWANCES UNDER NCRS COMPARED WITH ACRS

	ACRS 3-year	NCRS 4-year (0 percent inflation)	NCRS 4-year (5 percent inflation)
CURRENT 3-YEAR CLASS (per $1,000 investment)			
Year:			
1	$250	$160	$160
2	380	$300	$315
3	370	$300	$331
4		$300	$347
Nominal total	1,000	$1,060	$1,153
Inflation adjusted total	913	$1,060	$1,060
Present value:			
0 percent inflation	963	$1,000	
5 percent inflation	913		$1,000
Assumptions (percent):			
Real return	3.5		
Inflation	5.0		
Nominal discount rate	8.7		

AMOUNT OF DEPRECIATION ALLOWANCES UNDER NCRS COMPARED WITH ACRS

	ACRS 5-year	NCRS 6-year (0 percent inflation)	NCRS 6-year (5 percent inflation)
CURRENT 5-YEAR CLASS (per $1,000 investment)			
Year:			
1	$150	$100	$100
2	$220	$200	$210
3	$210	$200	$221
4	$210	$200	$232
5	$210	$200	$243
6		$200	$255
Nominal total	$1,000	$1,100	$1,260
Inflation adjusted total	$904	$1,100	$1,100

AMOUNT OF DEPRECIATION ALLOWANCES UNDER NCRS COMPARED WITH ACRS—Continued

	ACRS 5-year	NCRS 6-year (0 percent inflation)	NCRS 6-year (5 percent inflation)
Present value			
0 percent inflation	$931	$1,003	
5 percent inflation	$844		$1,003
Assumptions (percent):			
Real return	3.5		
Inflation	5.0		
Nominal discount rate	8.7		

AMOUNT OF DEPRECIATION ALLOWANCES UNDER NCRS COMPARED WITH ACRS

	ACRS 18-year	NCRS 25-year (0 percent inflation)	NCRS 25-year (5 percent inflation)
CURRENT 18-YEAR CLASS (per $1,000 investment)			
Year:			
1	$50	$40	$40
2	$90	$60	$63
3	$80	$60	$66
4	$80	$60	$69
5	$70	$60	$73
6	$60	$60	$77
7	$60	$60	$80
8	$50	$60	$84
9	$50	$60	$89
10	$50	$60	$93
11	$50	$60	$98
12	$50	$60	$103
13	$40	$60	$108
14	$40	$60	$113
15	$40	$60	$119
16	$40	$60	$125
17	$40	$60	$131
18	$40	$60	$138
19	$20	$60	$144
20		$60	$152
21		$60	$159
22		$60	$167
23		$60	$176
24		$60	$184
25		$60	$194
Nominal total	$1,000	$1,480	$2,844
Inflation adjusted total	$715	$1,480	$1,480
Present value:			
0 percent inflation	$785	$1,004	
5 percent inflation	$585		$1,004
Assumptions (percent):			
Real return	3.5		
Inflation	5.0		
Nominal discount rate	8.7		

Mr. Guarini. Thank you very much, Jack.

When you change the tax equation, usually, there are winners and losers. And tax reform, of course, as you pointed out was fair and simple and provides for economic growth. You put a lot of emphasis on economic growth.

If that were not proven to be the case, would there still be time for tax reform? Would fair and simple be adequate, or should economic growth be an essential ingredient before we go through the trauma of having tax reform?

Mr. KEMP. I do not think it should be traumatic for us to go forward with a fundamental overhaul of the tax system this year, Mr. Chairman. I think it would be traumatic to leave in place the inequities that exist in the Tax Code. I do not think the status quo is defensible. The saying goes, "If it ain't broke, don't fix it." Well, the tax system is "broke." I can make a case, and Senator Bradley and Dick Gephardt and others are making the case, that the tax system, for demonstrable reasons, is not doing what it should do in terms of the objective criteria for its performance.

So, (a) I do not think it should be traumatic; (b) I think all of us want economic growth, and lower tax rates will help us encourage economic growth if it is done in the proper way; and (c) I think it would also be in the interest of fairness and simplicity.

Mr. GUARINI. Have you given very much thought to transition rules, and could you comment on where you think we will have major problems there? Will we change our withholding system, our estimated tax system, and things of that sort?

Mr. KEMP. I have not spent as much time on that aspect as I have on the final shape of the Tax Code. I think ultimately, we are going to have to leave it up to some of the outstanding engineers of tax policy to figure out, for example, how you implement further indexing—beyond the few indexing provisions instituted in the 1981 law.

Don Regan has suggested that many of these things would have to be grandfathered. I would agree with that. And then there may be special circumstances considered on a case-by-case basis, that we are going to have to look at. But I do not think the problems are insurmountable, although there certainly are some difficulties along the way that Congress is going to have to take into consideration.

But the risk of doing nothing, I think, is greater than the risk of going forward with what is emerging as a bipartisan consensus for tax reform.

Mr. GUARINI. Thank you.

Do you think that simplification would be made more difficult by reason of the indexing provisions that you had in order to try and make it fairer?

Mr. KEMP. I am hesitant about calling this sweeping simplification, although I favor simplification. It does lead us into some difficult areas. But we already have difficulties, Mr. Chairman. And there are so many inequities in the Tax Code, where different sources of income are treated so disparately, that I think we can do a great deal of good. So again, I think the status quo is indefensible and that this committee could help fashion a very positive frame work for this debate.

Mr. GUARINI. Would you like to specifically state what this means to the average working man, to the middle American, would he benefit greatly by a reform of this type that you propose?

Mr. KEMP. My judgment is yes.

Mr. GUARINI. That's the average working American?

Mr. KEMP. Well, I'm thinking especially of my district which is mostly blue collar, but partly rural. And I know your district is probably pretty much the same in terms of the demographics.

As I said in my opening remarks, I think it would be particularly important to working men and women and to families with children; in my testimony I have made a case that treating sources of income in a more neutral fashion would be fairer. I think the effective tax rate would be lower on typical working men and women than it is today. I think those who are not paying taxes, both taxpayers at upper incomes and those corporations which are not paying taxes, would begin to pay more tax. I think it would broaden the base. And with regard to the budget deficit, I am convinced that if we do it correctly we will begin to see a diminution in shelters and a decline in underground economic activity, and a strong boost to our economy in 1985 and beyond. So I think tax reform would have a beneficial, not a deleterious impact upon the deficit.

Mr. GUARINI. Then lastly let me ask you, you have a single tax rate of 24 percent on individuals but a progressive tax rate on corporations. Could you comment on why you thought individuals should have a flat tax and whereas the corporations should have a progressive tax? Why did you make that distinction?

Mr. KEMP. Well, as I explained in my testimony, the flat tax rate is accompanied by some effective tax progressivity—that's why it's sometimes called a modified flat tax—through the exclusion of 20 percent of wages up to $40,000 and a phaseout at upper incomes.

Mr. GUARINI. Do the flat taxes progressive——

Mr. KEMP. The flat tax is modified to take into consideration the payroll tax, to treat different forms of income more neutrally, and to preserve basically the distribution of the burden of taxation as it is today.

I do not favor shifting the burden of taxation downward. In fact, I would point out that after the 1981 tax cut, Mr. Chairman, the actual burden of taxation has shifted upward, according to the empirical evidence coming out of Treasury, and other tax studies done since we lowered the rates. I accept the idea, as does the Bradley-Gephardt approach that we want some progressivity. But I think you can get the progressivity at less cost in revenue with a flat rate and a disappearing exclusion than with progressive marginal tax rates, so we can bring the rates down even lower than the 35-percent rate that the Treasury proposed advanced several months ago, for which I have not heard much defense recently.

Mr. GUARINI. Do you remember 1903, some 82 years ago, when we started the income tax, we were essentially taxed when the whole tax system began. And it seems interesting that it took 82 years to become a round circle.

Mr. KEMP. That probably is true, although there have been subsequent years, Mr. Chairman, of increases in marginal tax rates and dramatically lower tax rate.

In the 1920's the tax rates came down from the World War I peak of 77 percent to 25 percent. And in the 1930's it went back up. President Kennedy brought it back down, from the Second World War level of 91 to 70 percent. He would have liked to have gone further, to 65. President Reagan and some of us on both sides of the aisle have brought it down further, to 50 further. I believe that part of the entrepreneurial expansion which we have enjoyed, Mr. Chairman, is a direct response to the lower marginal tax rates across the board that were enacted in 1981. And according to yesterday's New York Times, Rajiv Gandhi, the Prime Minister of India, is advocating dropping the tax rate in India from 65 percent down into the forties and cutting the corporate rate, and he is getting accused of following some form of supply side economics. Excuse me for getting off on this subject.

Mr. GUARINI. Thank you very much. Cec Heftel.

Mr. HEFTEL. Mr. Kemp, I am concerned that we don't include the deficit in our dialog and I am concerned because it could lead, as I had said earlier in my testimony, to further disillusionment on the part of what I call middle America. I don't think that you can sensibly construct any kind of tax reform without—I am concerned about our failure to address in this same dialog tax reform and the deficits. I say this because if we pass tax reform and take away hard earned benefits to middle America basic things like health insurance, life insurance, in terms of fringe benefits that are not——

Mr. KEMP. My bill doesn't do that.

Mr. HEFTEL. No, no, I understand that. I am not addressing necessarily what you do or don't do. Let me——

Mr. KEMP. I don't want to defend someone else's plan, I would like to defend my own.

Mr. HEFTEL. But in any event, whatever we do if we don't address the deficit however you formulate your reform versus someone else's reform and you don't succeed in producing revenues needed how are you going to possibly address the problem without increasing taxes, and my concern is that we come out with a plan which reduces rates and then unable to address the problem of deficits, turn to tax increases, which would be the most disastrous thing we can do. And it is a philosophical question, it's not addressed to parts of yours or someone else's reform packet. It is just that I have asked what are you going to do to insure productivity, what are you going to do to insure economic growth. And without it you cannot handle the deficits. And that's what I would like to hear you address together.

Mr. KEMP. Well, I would say to my colleague, for whom I have a high regard, I totally agree with his premise that without increases in productivity, without increases in economic growth, there is no way you can handle or manage the deficit problem. Irrespective of our debate over cutting budgets or cutting deficits, it seems to me axiomatic that whether Bradley-Gephardt, Kemp-Kasten, or whatever eventuates from the Treasury is enacted, all of us want to encourage a higher degree of capital formation, more investment, more savings, more work opportunities for the American people. And I was suggesting that it seems to me increasingly clear that high marginal tax rates impede the growth of the economy that the gentlemen would like to see take place.

Last point: Harris-Bank in Chicago estimated that Kemp-Kasten would add $750 billion of new growth a year to the economy by 1990. Cumulatively that reduces the deficits by anywhere between $120 and $150 billion. Now, I am not basing this on some curve drawn on a napkin since all three bills are revenue-neutral in a static sense. It should be demonstrably evident, however, that by lowering the tax rates from 70 to 50, and cutting the capital gains in 1978 and again in 1981, we have had a favorable impact on the economy. This effort launched by my colleagues Dick Gephardt and Bill Bradley and advanced further by Jim Baker and Don Regan, and hopefully by the President in 1985, can encourage a more efficient allocation of capital, economic growth and bring about a higher degree of tax revenues, even if as a percent of GNP. I would not be against seeing revenues as a percent of GNP go up if we can do it by shrinking the underground economy, provide more efficiency, and allow the national income of our country to grow. So my goal is not at odds with your premise.

Mr. **Heftel**. My concern is that this is probably more like a crap shoot. And that the American people ought to be informed that we are running a risk because we don't know what the results will be, just as when in 1981 we adopted ACRS only to find that we dramatically decreased the amount of tax paid by corporate America and at the same time found that we didn't get the plant expansion and the new equipment expansion that we had hoped for. And I am concerned that we are telling the American people it's all going to happen almost mystically, and I don't think it will happen mystically. One of the reasons I keep asking about a 100-percent expensing on equipment and plant, the whole concept to cash-flow and the way that you treat consumption versus investments is that there you have a sure method of developing the kind of investment, the kind of savings you need, because when you bring down the interest rates you increase your productivity, there you know what you will get. And I am only concerned that there is a risk in what we are talking about and to have the public think they are buying something which will produce these results which doesn't, without telling them the risks involved concerns me, and that's all I wanted to share with you.

Mr. **Kemp**. Well, there are risks in everything we do. I am suggesting that the risks of doing nothing far outweigh the risk of designing a tax system for this country that would be both fair and simple and encourage economic growth. And I think you can demonstrate that lower marginal tax rates on corporate and personal income and on capital gains would have a beneficial impact, not only on the economy but on the revenue estimates of OMB. Mr. Chairman, the point about the ACRS, with all due respect, I think it is the investment tax credit coupled with ACRS that creates disparities in the treatment of different investments. Many countries in the world provide even shorter ranges of depreciation than the United States of America, so I don't think that ACRS is the problem that some people do, although I think it should be modified, as Kemp-Kasten does, to provide the economic equivalent of first-year expensing.

We take out the ITC, as does Bradley-Gephardt and the Treasury, though the other plans reduce the value of depreciation.

Mr. **Heftel**. But the point to be made is we did not get the new plant and equipment that we had anticipated and I am trying to say we have tried before and failed and we shouldn't oversell this time.

Mr. **Kemp**. I think your statement is at odds with the facts. This is an investment-led recovery. There are problems, there are issues that I think need to be redressed. Nonetheless, the recovery has not been a consumption-led recovery, it's been led by investment.

Mr. **Guarini.** Thank you, Mr. Heftel. Mr. Gregg.

Mr. **Gregg.** Thank you, Mr. Chairman. And I certainly want to congratulate Mr. Kemp for his leadership in this area of taxes and tax reform and being on the point for so many years. I also want to congratulate him for being the first witness I have heard who has come before this committee and say that we may not be getting the simplification. I really think we are making a big mistake in digging a rather deep hole for ourselves when we try to sell the American people that what's going to come out of this process is simplification, because I think we are going to end up with a code that's still fairly sophisticated and complex, although it will be reformed fundamentally.

You made a statement in your comments that I thought was interesting. You said you felt there would be an agreement reached with Treasury. Can you expand on that? To what extent do you think your proposal and the Kemp-Kasten proposal and the son of Treasury or whatever it's going to be called is going to be in conformance with each other, and in what areas do you see agreements being reached between you, and where are we going to be negotiating?

Mr. **Kemp.** I have really been encouraged, I would say to my colleague from New Hampshire, about statements by the chairman of this committee, Mr. Rostenkowski, by the distinguished gentleman from Tennessee, by Mr. Packwood in the Senate Finance Committee and by this emerging consensus. Maybe I am optimistic, but I just see a willingness to move forward in a bipartisan way. I will say, I don't think it can be done without a bipartisan effort. I don't think it can be the province of any one party. Having talked with Bill Bradley and Dick Gephardt I just want to publicly acknowledge that I think that they have made a significant contribution and I think the committee in moving these debates forward can play—I hate to use the word radical—but a radical role in restructuring our Tax Code to achieve the stated ends that we all desire.

In terms of simplicity, let me say to my friend, when I said that I didn't think it would be simple, I meant in part that there inevitably are many complexities involved in trying to go from the complicated system we have today to a new system; but right now, as you know, there are 14 to 15 brackets of taxation ranging from 11 to 50 percent. And I think reducing that from 14 to 3 as in Bradley-Gephardt, or to 1, with protection for the low-income working family as in Kemp-Kasten, would be significantly simpler than what we have today. We will be able to treat different types of income more neutrally and that that would also be more simple. In other respects, though, such as indexing of capital assets, there would be new complexity, though its complexity people are willing to live with because it protects them from a tax increase.

Mr. **Gregg.** I guess we will find out whether this Committee is capable of producing something simple. I guess I have more reservations about that. Treasury I and Kemp-Kasten simply don't agree. I mean, philosophically they don't agree, as I read them. What are the areas that you as one of the leading exponents on tax reform feel are sacred? What must be the philosophical underpinning of reform in order for it to be effective, and then when you answer that if you could merge in how the Treasury plan has to change to reach that point or how Bradley has to be worked in.

Mr. KEMP. Well, I am not hesitant about going into it, but I want to say at the outset that I appreciate the work that's been done on the Democratic side of the aisle and by the Treasury, and I would rather focus on some of the similarities today, not just the dissimilarities. I think we can reach an amalgam of the best of the three plans. To answer your question, with Treasury plan, No. 1, the rates are too high for me. I think the personal rate should be less than 30 percent. Second, I think they should move toward a flat rate and an exclusion rather than having three brackets, because of the advantages I outlined in my testimony. Third, I don't think we should tax capital gains as ordinary income. I think if there is anything that this committee and the Congress, in a bipartisan way have been able to prove over the past 8 years, it is that some differential for capital gains is helpful to the venture capital markets, the entrepreneurial climate and the formation of new enterprises and jobs in this country.

And I make it one of my highest priorities, I think most of us do, to foster more small business enterprises, to encourage more men and women to go into business, which has a very favorable impact upon the national unemployment rates and ultimately upon the deficit.

Next, I think tax reform should be pro-family. I think we have to take the personal exemption up to at least $2,000 to reverse what's happened to the inner-city poor and other families in this country whose very ability to stay together is threatened by the erosion of the personal exemption by inflation. Those would be some of the most serious problems that I would have with Treasury I and Bradley-Gephardt. But these problems can be overcome. I think we are approaching unity on the objectives as I stated in my testimony. So I am encouraged by that, and I am particularly encouraged by listening to the statements made by Mr. Rostenkowski and Mr. Bradley and Jimmy Baker at Treasury.

Mr. GUARINI. Thank you, Mr. Gregg. Mr. Russo.

Mr. RUSSO. Mr. Chairman, I would yield to the gentleman from New York.

Mr. GUARINI. Mr. Downey.

Mr. DOWNEY. Thank you, Mr. Chairman. Thank you, Mr. Russo. Jack, I think you are to be congratulated for this effort. You have been out on the point for some time, as was mentioned, and I think it is clearly something we should do.

Do you believe that at some juncture the President is going to have to embrace a specific set of proposals and say, "this is what I am for and this is what I intend to be for?" Do you believe he has to do that?

Mr. KEMP. Tom, not only does he have to for the effort to succeed, I believe he will, and I think it will be sooner rather than later. I think I agree with you, it has to be done in 1985 or the probability begins to diminish. And I hope it's done sometime in April, but it may be May, or later.

Mr. DOWNEY. Jack, let me ask you also with respect to the redistributional effects in your proposal. As I understand it Bradley-

Gephardt tries to keep the amounts basically raised from corporate and individual about the same, and Treasury, as you know, tries to raise about $150 to $160 billion more from the corporate side to reduce the individual rates. Can you give us some overview of your plan? I am assuming you are revenue neutral to begin with. Are you revenue neutral between corporate and individuals?

Mr. KEMP. It is revenue neutral on the personal side, I am told, although no final study has been done on the new version of Kemp-Kasten.

It is also distributionally neutral compared to current law, according to the Joint Committee on Taxation, on incomes up to $100,000. Over $100,000, the effective rate is marginally lower than Bradley-Gephardt, and you could make a case on a static analysis that we might have a slight decline in revenue from upper incomes. It's about the same in State's terms at upper incomes as the Treasury plan.

You know, this debate has been raging back and forth as to the benefits from the 1981 drop in the top tax rate. I simply rest my case on the fact that in 2 straight years after the tax cuts, Tom, revenues have been rising in America at incomes above $50,000, and I expect that with tax reform, sheltering and loopholes would also be reduced and that revenues actually would again rise among upper bracket taxpayers on the corporate side. On the corporate side it is revenue neutral.

Mr. DOWNEY. It is revenue neutral?

Mr. KEMP. Yes. It might be a slight increase in receipts from corporations, because compared with current law, we backload depreciation with what we call the economic equivalent of expensing: we provide a longer write off on the investment, but we increase the amount that can be written off; that is what is called neutral cost recovery.

Mr. DOWNEY. I am attracted to the idea of attempting to match tax lives with economic lives. I think that makes more sense.

Mr. KEMP. Plus we raised the corporate tax rate marginally compared with our original bill.

Mr. DOWNEY. And I am also attracted to your idea, and the Treasury's idea, that ITC has to be examined. I believe an argument could be made that we went too far in 1981 with ITC and 10-5-3. There were asset lives that were absurdly generous and, in fact, resulted in negative income taxes.

Can I ask you about the effect, in your view, of your proposal on our State, because you don't have a provision for the deductibility of State income taxes? I have had an opportunity in the last week to talk to a number of people who are deeply concerned. You retain, do you not, the deduction on property tax?

Mr. KEMP. Yes, we do.

Mr. DOWNEY. The State income tax deduction could be a real problem for businesses trying to decide where to locate and other individuals who may leave the State. Could you respond to that?

Mr. KEMP. Tom, I met last night with some people in real estate in New York City. I must say without mentioning names, there are all sorts of opinions about this with regard to New York City and New York State. I actually met some people who would like the tax rates to go back to 70 percent because they believe more capital was flowing into speculative tax shelter real estate deals when tax rates were higher. So let's face it, we have those who want to defend high marginal tax rates because it raises the amount of tax shelter capital. Having said that, by and large there is a lot of support for the reform. And, as you point out, Kemp-Kasten retains the deduction for the real property tax and removes the deductibility of the income tax.

What has hurt New York State is the high marginal tax rates on personal income in the first place. I am not now getting into a debate on partisan terms because it was a Republican Governor who helped raise the rates and it was a Democratic Governor who brought the top 15-percent bracket on wages down to 10 and lowered the 15-percent bracket on so-called unearned income to 14, and now the Governor is talking about a teeny-weeny tax rate reduction for 1986. I think New York State should be encouraged, as Felix Rohatyn has recently suggested, to move to some form of a modified flat tax for New York State. I don't want to do anything, nor do you, that would hurt our own State. Because New Yorkers are in higher than average brackets, lowering the tax rate at the Federal level shifts billions of dollars back into the pockets of New York taxpayers and by definition would do more for New York than most other States, without harming the rest of the country.

I have said I am willing to negotiate on any issue. I assume that Bradley-Gephardt, and Kemp, and Kasten, and Downey, and Rostenkowski, and Duncan and by the time this finishes a lot of people are going to be involved.

But unfortunately, Tom, most of the New York debate is only associated with removing the deduction, while leaving the rest of the tax system as it is, without looking at the benefit that would accrue to the country and to our State if we drop the top tax rate down 30 or less.

Mr. DOWNEY. One additional comment. I also think with respect to the double deduction, that for the average taxpayer you are going to help them a great deal, and also the children. My last comment would pertain to the question of capital gains. As far as I can tell, the notion of indexing basis is remarkably complicated. I mean, how do you determine in a big investment scheme whose basis is indexed and when? So I would hope that you would consider, and I know the members of the committee do as well, retaining the current law with respect to deductions and exclusions. It might be remarkable to hear that come from me, but I think that the system works, that it has encouraged investment, and needs to be retained.

Mr. KEMP. We give two choices: to tax gains as ordinary income and have the basis indexed to get an exclusion of 40 percent without indexing, which would lower the top rate to about 17 percent. There are high risk ventures that we want to encourage. There is long-term lower-rise financing that we also want to encourage, that could be taxed at ordinary income if you indexed the basis. There are problems with indexing no doubt, but I think they can be overcome.

Mr. GUARINI. Thank you, Mr. Downey. We will stay with New York, with Mr. McGrath.

Mr. McGrath. Thank you, Mr. Chairman, and welcome, Jack. As I understand your plan as opposed to the Treasury plan and the others, you retain the property tax as a deduction, you retain ACRS, indexation of rates, you don't tax fringe benefits, you increase the personal deduction. One of the criticisms, as I understand it, of your plan is that it produces a revenue shortfall. Could you explain that?

Mr. Kemp. A revenue shortfall?

Mr. McGrath. Yes. It's not revenue neutral to the Government, am I correct?

Mr. Kemp. The original Kemp-Kasten lost about $5 billion on the corporate side, we found out. We made a few modifications so that we could in good faith go in there with Mr. Bradley and Mr. Gephardt, this committee and the Senate Finance Committee and present on a static basis a revenue neutral bill. We lowered the tax rate on the business side to 35 instead of 30 and modified the ACRS system in a way that was less front loaded. It is the economic equivalent of first year expensing, but it actually raises revenue for many years because it stretches out the writeoffs over a longer period though increasing the total amount that can be written off.

So I think we are within the same ballpark as Bradley-Gephardt and the Treasury bill if you look at it in a static sense.

Mr. McGrath. I am told by Treasury that the property tax deduction is worth about $40 billion and that it becomes a problem for them to reintroduce this as a deduction and as a result probably—in my estimation, and I am asking this question in your estimation, does that make the bill as it might come out of some compromise with a lack of a deduction in it for property taxes. This may get a fatally flawed bill.

Mr. Kemp. Ray, I understood that the property tax deduction was 40 percent of that $40 billion, not the full $40 billion. I may be wrong, but my understanding of the property tax deduction was that it represented 40 percent.

Mr. McGrath. Well, I may be incorrect. I will check that.

Mr. Kemp. I am sorry I don't have it with me, but I am told by my staff that it's 40 percent of that total $40 billion. But the total deductibility of the State income tax and the property tax amounts to about $40 billion, and of that the property tax represents about——

Mr. McGrath. I was given a higher figure for the entire State and local income tax, plus the property tax. I was told it was about $54 billion.

Let me ask you one final question, Jack. In doing this, broadening the base, excluding a lot of deductions that have already been enacted in years gone by, what does this proposal or these proposals do to enterprise zones in terms of another credit, another tax preference?

Mr. Kemp. There is no doubt about it, the enterprise zones is a compensatory use of the Tax Code to try to stimulate small business entrepreneurship in those areas of the country that have tragically high unemployment rates and a shrinking tax base.

I don't think it conflicts except on the surface. I just happen to think it is good social policy, just as we retain the deductibility of interest on mortgages, and property taxes, to encourage home ownership. We should be willing to go beyond the current Tax Code and say to any man or woman who invests in an area of very high unemployment that we would abolish the capital gains tax or roll it over to get that person to take an extraordinary risk of investing in the new enterprise to create jobs in those areas of our country that have been left outside the recovery. So I guess it depends on what your social philosophy is. Should we do something extra to try to reach the lives of low-income workers or low-income unemployed folks in those areas of our country where there is such tragic high unemployment and loss of population.

Mr. GUARINI. Thank you, Jack. Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman. We want to add our voice of welcome and congratulations for the hard work that you have put forth in the effort to bring before us today the legislation that we have. Jack, someone alluded a little earlier to the change on capital gains. Your first bill that went in didn't really recognize that differential explicitly. Why did you this time choose to change and to have or put in the capital gains lower rate over your first bill?

Mr. KEMP. The first bill did say that for 10 years we would optionally give capital gains the kind of preferential treatment it was getting today, which would have lowered to top tax rate from 20 to 19 percent. Then after those 10 years it could only be indexed and then taxed as ordinary income. But our marginal tax rate was significantly lower than the competing bills.

Mr. CAMPBELL. But you now feel that we need to keep the preferential treatment in order to attract risk capital.

Mr. KEMP. Yes; I think there are some forms of economic risk or venture in this economy that have not only an extraordinary risk but an extraordinary technological and job creation potential that should be encouraged by tax policy. I would simply point to the 1978 Steiger amendment and the 1981 Kemp-Roth bill each of which cut the tax rate by about one-third for capital gains; there is a lot of empirical data that leads us to the conclusion that the venture capital markets in America have expanded in such an extraordinary fashion that it has had a significant positive impact upon this economy, which has generated 7 million new jobs.

Mr. CAMPBELL. So it is your opinion, and you mentioned awhile ago that after we go through it and hash all of these proposals out, but it is your opinion then that whatever we come out with ought to retain the preferential treatment for capital gains?

Mr. KEMP. I think certainly in terms of the venture markets of America.

Mr. CAMPBELL. For venture market capital?

Mr. KEMP. It is justified, yes.

Mr. CAMPBELL. We had this morning, as you know, Senator Bradley and Representative Gephardt and we discussed some of the proposals that they had. There was a concern that I expressed that as we went through their legislation, it turned out to be a very large tax increase on individuals.

There were quite a few little models to see how it was impacted after, say, a 25-percent inflation 6 years down the road or whatever you happen to have. And it seemed to be a very large increase in taxes. You retain indexing for brackets. Personal exemptions you index the zero bracket; and, of course, they do not.

So, what I am driving at is do you think it is essential in any reform that where we do change the rates or the structure that we retain a protection from inflation such as you have done in indexing? You think that is an imperative?

Mr. KEMP. I think it is self-evident that you cannot have fairness in the Tax Code if you tax people on nominal as opposed to real income. So I definitely favor, in the interest of fairness and efficiency, indexing the Tax Code, not only on the personal——

Mr. CAMPBELL. Not to do that and call something revenue neutral or balanced really——

Mr. KEMP. That's one reason I would say to my friend from South Carolina that the Bradley-Gephardt bill in a static sense raises revenue over time. It takes out indexing of rates and exemptions and raises the tax on capital gains. But I think most of us in this room now recognize that to raise taxes on capital gains or even on personal income begins to yield a diminishing return in terms of revenues and is counterproductive. So, yes, I favor indexing.

Mr. CAMPBELL. Let me ask you another question. On the corporate rate, if I remember correctly in looking at Bradley-Gephardt, they did not have any graduation in the corporate rate.

Now, how does your legislation treat the corporate rate?

Mr. KEMP. Slight graduation; 15 percent on corporations with taxable incomes below $50,000.

Mr. CAMPBELL. Is this an attempt to recognize that small corporations should not be penalized and that in that sense there should be a lower rate?

Mr. KEMP. Trying to foster the growth-oriented small business sector and recognizing that profitability and retained earnings are so critical to the capital stock of a small company, I would rather see a slight——

Mr. CAMPBELL. Why did you have a cliff though? I mean why did you go 15 percent and then $50,000 and off a cliff? Why wasn't there any more graduation in that?

Mr. KEMP. Yes, it is 15, 25 and 35.

Mr. CAMPBELL. OK.

Mr. KEMP. It's 15——

Mr. CAMPBELL. Is that a 100,000 split?

Mr. KEMP. Twenty-five percent in between 50 and 100 and then over 100 it is 35 percent.

Mr. CAMPBELL. Yes, I agree with that idea, and I was just interested in the gentleman's thoughts on it.

Thank you. My time is up.

Mr. GUARINI. Mr. Russo.

Mr. RUSSO. Thank you very much, Mr. Chairman. Jack, it is a pleasure to speak to you about taxes and economic well-being in this country.

One of the things that I think is interesting as the debate is going to bring forward is that this is going to be a combination of the largest tax cut and largest tax increase in history in order to achieve revenue neutrality. The reason I say that, Jack, in looking at the Treasury proposal, they basically in the rate just reduce taxes $483 billion on the individual side, and then pick up through base broadening about $335 billion.

So, in essence, they lose $148 billion on the individual side. Then we go to the corporate side of Treasury's program and they cut rates to 33 percent, which is a reduction of $204 billion of revenues and then they raise about $369 billion through an increase in the revenue base.

This nets out to about $165 billion, which, in essence, is revenue neutral to the tune of about $18 billion.

In your response to Mr. Downey, on whether your plan is revenue neutral, do you have a breakdown of how the new proposal deals with how dollars shift from each side of the ledger, from the individual and the corporate?

Mr. **Kemp**. We have asked the Joint Tax Committee for that information. They did it for Kemp-Kasten I. They have not yet done it on Kemp-Kasten II. We are waiting for that to be done, and I will be glad to submit it.

Mr. **Russo**. I think it would be important to see how we arrive at these numbers, Jack.

Mr. **Kemp**. I agree. Could I make just one slight point with regard to your first statement?

Mr. **Russo**. Sure.

Mr. **Kemp**. We need at some point in this debate to intellectually jettison the current code and think of what would be happening in the new tax system——

Mr. **Russo**. I understand, Jack, but there are some winners and losers in this change. Everyone thinks they are a winner just because you reduce the rates, and all I want to make sure is that when we discuss this new proposal, that people understand there are losers and winners.

When I look at your proposal, I notice your rate is 24 percent for everything. I look at four-fifths of 24 for the earned income. When I look at Treasury's 15–25–35 and then corporations are only 33. Well, somewhere down the line if they are both revenue neutral, somebody has to pay more money in your program as opposed to Treasury's.

The way I look at it, the low-income family, even if he gets the four-fifths of the 24 pays a rate of 18. So in the early end, yours is about three points higher than what Treasury does for that low-income family.

Mr. **Kemp**. The difference is that the marginal rate would be 19, but the effective tax rate on that family would be much lower because of our exemptions and exclusion.

Mr. **Russo**. But it would be much lower for Treasury's, too.

Mr. **Kemp**. Could I make just one quick point, and I think it is important.

Mr. **Russo**. I think it is important to clarify the record.

Mr. **Kemp**. Well, sometimes the winners and losers will be the very same people. In other words, you could lose something in terms of the investment tax credit, but you could gain something in a lower rate or better depreciation that would improve your ability to invest and make it more profitable.

Mr. **Russo**. I understand, but we are going to get a lot of pain from whichever proposal we look at, and the question is what kind of gain do you get for the pain, because you are not going to raise revenues.

As I understand your proposal, Bradley-Gephardt, even Treasury's, nobody wants to come out ahead and reduce the deficit because this doesn't raise any revenues.

Mr. **Kemp**. In answer to a previous question, I said I hope it gains revenue through growth. You see, we have the same problem in this debate as we do in the budget. We have got to find an assumption upon which the different parties can come together. One of the basic assumptions is static revenue neutrality, but I think it is intuitive as well as intellectually defensible to suggest that with rates closer to 25 than to 50 and the corporate rate closer to 30 than to 46 and with proper depreciation schedules and if we can treat capital gains to encourage a spirit of entrepreneurship, we will end up with a more efficient economy and a lower deficit.

Mr. **Russo**. Those were the same intellectual arguments that we heard regarding the original 1981 tax cut that was supposed to generate so much productivity and so much growth and bring tax revenues in so we wouldn't have the deficits that we have today. But we put that bill into place and we have got all these tax reductions and what we have is larger deficits.

Mr. **Kemp**. Well, Marty, if you look at revenues for the country, they are roughly 19 percent of GNP, the same as before the tax cuts.

Mr. **Russo**. Yes, but they went down to 17 after the 1981 tax cut.

Mr. **Kemp**. Those were projections. Revenues have been rising since the——

Mr. **Russo**. Yes, but we put five tax bills in since that tax cut.

Mr. **Kemp**. Well, yes, that's——

Mr. **Russo**. Right? Am I right?

Mr. **Kemp** [continuing]. No doubt true.

Mr. **Russo**. OK.

Mr. **Kemp**. But revenues are rising among all income classes above $50,000, so there has been a demonstrable increase in the amount of revenue that is flowing into the U.S. Treasury.

Mr. **Russo**. It took us five tax bills to do it.

Mr. **Kemp**. Could I just finish my statement?

Mr. **Russo**. Sure.

Mr. **Kemp**. Just for the record, I want the record to show that among taxpayers above $75,000, revenues rose 11 percent in 2 years, despite a cut in the top tax rate from 70 to 50 percent. They paid a larger share of the total tax burden than at any time in the last 15 years—23.3 percent in 1983, 20.4 percent in 1981. The share of tax paid by millionaires has more than doubled. So I think that the case has been made that the fashioning of a new tax system would have a not beneficial impact, upon revenues.

Mr. **Russo**. I would hope past history is not something we rely on, but I hope you are right. Let me just ask you one last question.

Assuming that tax reform goes through, would you—or if it doesn't go through, either way, would you favor at least a minimum tax on both individuals and corporations of at least 25 percent? If their minimum tax—on $100,000 of adjusted gross income?

Mr. **Kemp**. The answer to that is that the time is ripe for an overhaul of the tax system. I favor a 24 percent flat tax rate, but if you put a 25-percent minimum tax on top of this Tax Code, I would vote against it.

Mr. Russo. Well, I think it would be to make——

Mr. Kemp. You are not treating different sources of income the same way. It would be unfair.

Mr. Russo. Well, what happens if this doesn't pass?

Mr. Kemp. I think it will pass.

Mr. Russo. I hope you are right.

Mr. Kemp. Well, I'm glad to hear that. That's encouraging.

Mr. Guarini. Is that a concession? Thank you, Mr. Russo. Mr. Duncan.

Mr. Duncan. Thank you, Mr. Chairman. I want to join in complimentin. you, Jack, upon the extensive effort that you have expended on this particular subject. I just have two or three questions, and you may have answered some of them in the past.

Have you done analyses of your proposal as to how it affects the relative tax burdens of different groups?

Mr. Kemp. Individual groups?

Mr. Duncan. Yes, sir.

Mr. Kemp. According to the Tax Committee, the Joint Tax Committee, up to $100,000 the burden is the same as under current law.

I accept the fact that people should pay taxes according to their ability to pay, and we are told by the Joint Taxation Committee that is neutral or statically neutral up through the income tax classes right now. Over $100,000, as I said in response to a previous question, on a static basis—ignoring the response we have witnessed—there would be a small revenue loss—about the same as the Treasury.

I do base part of my case on the fact that the wealthy are paying higher taxes under Ronald Reagan than they were paying when the tax rates were higher under Jimmy Carter.

Mr. Duncan. I have been advised by staff that a pure flat tax to raise the same amount of money would affect the poor, lower middle income taxpayers and they would pay a greater burden of the tax liability than under the current law; is that correct?

Mr. Kemp. That would be the immediate impact. I have avoided a pure flat income tax for that reason. Interestingly enough though, Kemp-Kasten is designed to result in an almost flat combined income and payroll tax, and this avoids shifting the tax burden by income class. I think that the flat tax movement in America has done a lot to propel this issue to the point where, according to yesterday's USA Today, believe it or not, that about 80 percent of the American people want the type of tax reform that is beginning to emerge from this consensus.

Mr. Duncan. Could you contrast the incentives for capital formation in your proposal as compared with the Treasury proposal and the other different proposals?

Mr. Kemp. Well, I think that compared with Treasury I, and as Don Regan pointed out, it was written on a word processor Kemp-Kasten lowers the cost of capital.

Cutting capital gains rates, I think, would be more effective than raising capital gains tax rates as does Bradley-Gephardt and Treasury I. We change the ACRS to something that I call the neutral cost recovery system, which encourages capital formation, plus we lower the top tax rates on savings and dividends significantly, so I think you could make a case that the capital stock of the country would rise significantly under Kemp-Kasten.

Mr. DUNCAN. How do you respond to the homebuilders, the study that they had conducted? You probably have read the homebuilders rather extensive study of all the proposals and particularly the Treasury, and they indicate that it would be devastating to their industry. The Treasury, the Bradley-Gephardt would, but yours would affect it, but not as severe as the other two.

How do you respond to that? But either one they indicated would raise rents on low-income housing as much as 35 percent or something.

Mr. KEMP. I've seen those studies by the NAHB and they find that Kemp-Kasten would lower the cost of home ownership to families earning up to or above the median income. There are all sorts of studies, I would say to my colleague. My bill actually is quite favorably reviewed by many of the analyses done by the real estate and home building industry.

We find that by the new depreciation schedules, we increase the value of depreciation for real estate under Kemp-Kasten by 70 percent in real terms over current law. Instead of 100 percent over 18 years you can write off 148 percent plus indexing over 25 years.

Mr. DUNCAN. Now, you leave charitable giving intact?

Mr. KEMP. I leave charitable contributions alone. I think I would make good social policy to leave charitable contributions fully deductible as under current law.

I think we make a very serious error here if like the Treasury we begin to treat upper income contributions differently from other people who give to their church, synagogue or fraternal organization or the Knights of Columbus or whatever organization it might be. I favor full deductibility of charitable contributions.

Mr. DUNCAN. Thank you. My time is up. Thank you very much. We look forward to working with you.

Mr. GUARINI. Thank you, Mr. Duncan.

Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman. I, too, want to congratulate our distinguished colleague for his efforts now going back many years on behalf of significant tax reform and trying to restore some lost incentives to our tax program, and I share your sentiments exactly about the restoration of incentives coming out of the 1981 bill, which you were the principal architect of.

One thing you mentioned, Jack, that I'd like to ask. As a principle, I mean, you indicated that you accept or believe and embrace the idea of progressivity? I mean now do you really believe, aside from the economic and political considerations, because we are talking about two profoundly different concepts, and a proportional tax, it seems to me in the best of all worlds, is not only morally defensible, but I would argue it is economically defensible, too, which is not to say that it necessarily in the current climate would gain acceptance.

Mr. KEMP. The problem is twofold. Part of it is political. But in the economic sense, Phil, the payroll tax added to a flat income tax results in a regressive Federal tax rate. So you are imposing a higher combined tax rate on low-income working men and women than on higher income taxpayers when you enact a perfectly flat income tax, because the total rate does not turn out to be flat.

Mr. CRANE. Well, wait. Before you go further. If you have, for example, an exemption for benefit of the working poor, as every proposal I've seen has, there is to that extent a progressive ingredient. Frankly, I've got one that would provide a $10,000 or whatever the poverty level is exemption for anyone who works, but that would be the only exemption, deduction, or exclusion that would be preserved.

For all of that, that means that the person making $20,000 paying 10 percent, say, on $20,000 with a $10,000 exemption actually is only paying $100.

Mr. KEMP. Phil, you just——

Mr. CRANE. Or I mean $1,000.

Mr. KEMP. Phil Crane, you have just accepted a modest degree of progressivity in your new tax——

Mr. CRANE. Well——

Mr. KEMP [continuing]. All due respect.

Mr. CRANE. To be sure. To be sure. But as I say, I don't see any basis for taxing people below what we've defined to be a poverty level. We have a lot of programs, you know, to try and give them inkind additional income on top of that which probably ought to be reviewed, you know, if you went to the concept.

But I am talking about the idea of putting escalating tax burdens on people for being successful.

Mr. KEMP. Well, I have a flat tax at 24 percent.

Mr. CRANE. Well, I thought yours ranged between 20 and 28?

Mr. KEMP. The effective or average tax rate would range between 0 and 28, but we have a flat marginal tax rate of 24. That's the beauty of the modified flat tax. So yours is also modified.

Mr. CRANE. Well, no, that's a modified progressive income tax. Please don't use, you know, tnat's like Bradley-Gephardt, you know, I've seen that phrase modified flat tax, and it is a modified progressive income tax.

Mr. KEMP. No, I'm not trying to get into an argument with you. It is a flat tax rate of 24 percent modified through the 20 percent exclusion on wage income up to $40,000 and doubling of the family exemption, which removes the very same people from the Federal income tax rolls that I think you would like to see removed.

So, again, I could theoretically accept some progressivity, just as Phil Crane does, the extent of which is debatable, but I think if we could get concurrence or a consensus on bringing the rates down to half of what they are today, I'd be willing, I think, as I think you would, to try to modify or allow for some progressivity within that range.

Mr. CRANE. Oh, I'm not trying to quarrel with you because I think you have come the closest of these various modified plans to the ideal.

Let me ask you one other thing, and this is in connection with some discussion we had this morning with our colleagues, Senator Bradley and Dick Gephardt. I told them that it seems to me that the Achilles heel in their proposal is repeal of indexation, because while they argue that 80 percent of people would be in their lowest bracket of 14 percent right now. Within 10 years it may be exactly the reverse where you have got 80 percent of them in their maximum bracket; and that, in fact, has been one of the most punitive aspects of our Tax Code.

Would you agree that Bradley-Gephardt, in fact, is not revenue neutral? It lays the foundation for massive increases in personal taxes and also skews the ratios that we currently have which they are trying to preserve today between personal as well as business taxes. You end up with a significant increase in the personal load.

Mr. KEMP. I share the gentleman's belief that indexing is both an issue of fairness and an issue of efficiency, because not only would the low-income working man and woman be pushed up into the higher brackets, the low-income people, you know, the people at the poverty level or just above would be pushed into the first bracket under Bradley-Gephardt by inflation.

Ideally of course, the gentleman from Illinois and this gentleman, as hard money advocates, would prefer to hold inflation down through monetary policy and rely on tax policy to encourage the highest employment of the utilization of America's resources, both physical and human and I hope that we never return to the days in which we had 13-percent inflation, putting steelworkers in Buffalo or auto workers in Illinois into 40 percent marginal tax brackets where they are today.

Mr. CRANE. I would hope so, but, Jack, you know, based upon the sorry experience we have of watching what this Government has done on a post-World War II era, I wouldn't hold my breath, and that's why I think that that, as I say, is the one major flaw of our colleagues alternative to Kemp-Kasten.

Mr. KEMP. Well, that's why we preserve indexing in Kemp-Kasten—as a sort of insurance policy against inflation.

Mr. CRANE. Thank you. My time is up.

Mr. GUARINI. Thank you, Mr. Crane.

Mr. Henson Moore.

Mr. MOORE. Jack, I, too, thank you. You have had a more profound impact on tax policy than most members of the Ways and Means Committee ever have and you have done it as a nonmember. Your work on the Kemp-Roth bill is something to be proud of. I am certain that tax cut would never have occurred had it not been for the two of you convincing a President and a Congress and certainly you are now taking the lead again in a field in which I believe the American people are just as desirous as they were of getting our tax rates down to more historic and reasonable levels.

Let me just simply say I agree with the initial statement in your testimony. I also am convinced Congress is going to pass tax simplification. They are going to do it this year. I think most people here in Washington, including the press and the lobbyists tend to think that all the wisdom of the country is here in Washington. They don't realize that there is a great country out there that believes that the present Tax Code is unfair and inefficient.

The people are right. The politicians, the lobbyists, and the press here in Washington are wrong, and I think we are going to see this thing pass expressing the will of the American people in changing our tax law.

Also there is something, I think, that we are really missing the bet on and that is to home in on the fact that although all of these tax proposals are revenue neutral, they really aren't. Through improved compliance we are going to get at that $100 billion a year in income taxes we are leaving on the table every year, and I will never, for one, vote to increase taxes on the working people of this country until we make an effort to collect that $100 billion.

Tax simplification will do it. Nobody can seem to give me a figure on how much, but we know that $80 billion of that is individual income taxes involved in lawful activities, and so, I congratulate you. Thank you for being here, and you are on the right track.

Mr. KEMP. Thank you.

Mr. GUARINI. Are there any other questions?

Jack, I want to thank you for your thoughtful testimony and appreciate the great contribution that you have made to tax reform. You have led the national debate on a very critical issue. We are very indebted to you and your testimony has been very well received. Thank you very much, Jack.

I'd like to call Mark D. Siljander, a Member of Congress from Michigan. We welcome you. We'll accept your statement into the record and appreciate if you would begin.

Thank you.

STATEMENT OF HON. MARK D. SILJANDER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. SILJANDER. Mr. Chairman, I appreciate your giving me your time and the committee's time to hear my testimony. I ask permission, if there is no objection from you, Mr. Chairman, to submit my testimony in full and simply outline in general terms the Siljander approach to tax reform, if I may.

Mr. GUARINI. Your testimony will be included.

Mr. SILJANDER. Thank you, Mr. Chairman. I set out last May, a very short time ago, with a bill that was introduced by myself and Senator Nichols of Oklahoma in the last session of Congress.

The bill is not perfect. The bill has not been scrutinized every jot and tittle by hosts of tax lawyers. What we were after essentially, Mr. Chairman, was a philosophic approach to tax reform. So, in that light, I'd like to present the Siljander approach, which will likely be introduced in the near future by Senator Humphrey over in the Senate. I would like to present my testimony on the 10-percent flat rate tax in a general philosophical tone.

I have not had the honor of serving on this prestigious committee, and, as a result, I have not had the analyses done on my bill that are available to members of the committee. So, my analyses are done by outside groups, outside economists and also internally by my own staff. So bearing that in mind, I'd like to bring you to where we were in May and where we are today.

We started out with the idea that we introduced in the legislation. Today our bill has the support of 30 national groups. Several million Americans around the country have expressed an interest in the Siljander approach to tax reform.

When Treasury held their hearings on various tax reform issues where I testified, I am told they received over 350,000 communications from individual taxpayers across America telling the Treasury that they support the concept embodied in the Siljander-Nichols bill of last session.

The Siljander bill is very simple, and that is a main goal, I think, of this committee and the effort of many of us in the tax reform movement. We are attempting to make a presently complicated, confusing and I would say in some degree elitist tax system more fair and more simple.

Now, what our bill does is bring a new approach to tax reform. It brings a new dynamic into the discussion, and that is what I hope to show with my testimony, Mr. Chairman.

Now, what the bill does is the following: We would allow deductions for charity as in present law, a $2,000 exemption indexed to inflation, which deals with the poor more fairly than the present system. We allow deductions for IRA and Keogh under the same system as we now have. We allow normal business deductions for nonincorporated businesses and we allow State and local property tax and interest deductions as well.

The idea behind our bill initially was to address the squeaky wheel. The squeaky wheel at that time were, the millions of taxpayers who are very, very frustrated with the system. As a result, we deal only with individual and nonincorporated taxpayers. We do not yet deal with the corporate tax code.

Our more unique approach behind the tax system as I earlier alluded to embodies the concept of amnesty. The Siljander bill would not take effect, Mr. Chairman, for 3 years once passed by law. So, assuming this Congress had enough wisdom to pass it this year, it would be 1989 before the bill would take effect.

However, immediately upon passage of the bill, a 3-year amnesty program for the legal underground economy would take effect. The IRS has estimated that that legal underground economy could equal as much as $100 billion lost revenue to the Federal Government each year.

So, what our bill would do is offer an amnesty which would include simply paying back taxes at a reasonable interest rate without fear of civil or criminal penalties, and that amnesty, such as embodied in the Massachusetts example, which was extremely successful, is embodied in the Siljander approach.

In Massachusetts, for example, Mr. Chairman, they believed in their 3 month amnesty that their revenue increase would be approximately $6.5 million, which really isn't bad for a State the size of Massachusetts. Close to a year after the 3 months amnesty has expired, they are still counting revenues at $82 million. The amnesty was successful.

And the other interesting caveat, is that they didn't change the basic rates or the system. Massachusetts simply offered an opportunity for taxpayers in that State to surface and become honest taxpaying citizens. And the two major reasons why we have such an incredibly large underground economy are because the rates are too high and the system is so complicated and so confusing that it is easier not to pay taxes than to participate. Individuals pay over

$60 billion a year for assistance in having their tax forms filled out.

So, I argue that an amnesty provision nationally, as the Speaker of the House has equally argued far more articulately than I, is a logical approach to offer an out for those who have been ingrained in the underground economy.

Now, what makes this unique, we believe that the 10 percent rate that our bill offers and the simplicity of the system will be the key factors to encourage at least the same amount of participation as Massachusetts and probably more. Every penny of the back taxes received would go into an amnesty trust fund, and accumulate over that 3-year period before phase II begins. Phase II is the institution of the 10-percent flat rate.

Now, many argue that 10-percent is ridiculous. We will never raise an appropriate amount of revenues they say. Well, the amnesty trust fund is our safety net. The amnesty trust fund over 3 years, based on the experience of Massachusetts and IRS estimates, could raise anywhere from $80 to $150 billion over 3 years in back taxes and interest.

If I am wrong in believing in the dynamic effects of H.R. 200 that safety net would protect us like an insurance policy against a large increase in the deficit. I am convinced that a 10-percent marginal rate or a 10-percent withholding on paychecks versus the average of 26 to 30 percent on incomes under $40,000 would be a tremendous incentive, a dynamic incentive to our economy by giving working Americans more take-home pay.

I agree there would be a demand effect, because certainly if we increase take-home pay that substantially, middle-class Americans will use that money to purchase products which would create an increase in the GNP which would in turn, stimulate the economy. We all know the dynamic scenerio.

On the supply side, more Americans would be able to save and invest more of their net take-home pay. The bottom line according to the Chamber of Commerce research and studies, in terms of how much dynamic effect our Tax Code has with middle-income American's purchasing power lies in net take-home pay.

So, I argue that if I am completely wrong and there will not be a dynamic effect in the supply and demand side by reducing marginal rates to 10 percent, if I am totally wrong and the static economists are correct, then we have a trust fund that would offset even the worst revenue loss under static assumptions for at least 1½ to 2½ years depending how successful the amnesty was to begin with.

So, I argue let's give the dynamic effect of lowering tax rates a chance. It was argued by one of my colleagues, Congressman Kemp, that we have a risk in the Bradley-Gephardt. There is also a risk in the Kemp-Kasten. There is a risk in the Treasury proposal. Well, I argue that while my bill sounds a little bit more extreme than others with a 10-percent rate, it probably has the least amount of overall risk of all the proposals because of this safety net feature of the amnesty trust fund.

So, conceptually, Mr. Chairman, not specifically to H.R. 200, which I agree could use some more careful scrutiny, but conceptually, I believe with expanding the base of taxpayers by uncorporating the underground economy and with the dynamic effect that a

10-percent rate would have on the economy, the resulting reduction in outlays and the elimination of so many tax shelters, that this proposition could be revenue neutral.

And, if it isn't, and if I am wrong, then the Congress still has the option to raise that 10-percent rate before it would have a prohibitive effect on the budgetary concerns of Congress.

So, my argument lies in the fact that this is the only proposal, Mr. Chairman, that has this safety net feature.

[The prepared statement follows:]

STATEMENT OF HON. MARK D. SILJANDER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. Chairman and Distinguished Members of the Committee, in 1913, an amendment was added to the U.S. Constitutions that allowed the government to start taxing our personal income. The maximum rate at that time was 7 percent. Today, the federal government can take as much as fifty cents of every dollar we earn.

Today, the Internal Revenue Code is about 10,000 pages long. It is riddled with loopholes which enable those who are rich enough to hire experts to help them "beat the system."

Americans spent over 613 million hours completing some 260 different tax forms. The large inconvenience and loss of time caused by the completion of tax forms is in addition to the complexity and expense of the system. In 1954 18 percent of all taxpayers had their taxes prepared. In 1981, 52 percent of all 1040 forms were professionally prepared at a cost of $60 billion.

In fact, despite the professional help, tax computation errors continue. In 1979, 7.3 percent of the 90 million tax returns had errors in their tax calculations. In 1979, some 3.8 million underestimated their tax burden while 2 million overestimated their taxes.

Those who are not rich enough do one of two things. They wrestle with an octapus of forms, instruction booklets, attachments, addendums, tables, charts, updates and advisories and wind up with eye-strain, a migraine headache, an upset stomach and the paranoia of an audit lurking around the next mail delivery.

Then there's another group of people who have found a simpler solution. They don't pay taxes. Studies have revealed recently that the so-called "underground economy" created by these people amounts to nearly one trillion dollars.

"The income tax has made more liars out of the American people than golf has," said Will Rogers. "Even when you make a tax form out on the level, you don't know when it's through if you are a crook or a martyr."

Of course, the Will Rogers himself might be surprised when the record of the IRS staff is considered. A 1975 IRS survey of its trained employees showed that they computed the wrong tax 72% of the time, even when handling relatively simple tax problems. Another IRS survey in 1971 showed an even higher error rate of 82% on low income returns with itemized deductions. Finally, Ralph Nader's Tax Reform Research Group sent identical "test" tax returns to 22 different IRS offices. Each office calculated a different tax liability, ranging from a high refund of $811.96 to an underpayment of $52.14.

More than two decades ago, Nobel Laureate economist Milton Friedman came up with the idea of a "flat tax". Several administrations considered the idea. But it wasn't until 1976 that Treasury Secretary William Simon ordered a study called "Blueprint for Basic Tax Reform".

In the report the Department of the Treasury discovered that "there has been increasingly widespread dissatisfaction in the United States with the Federal tax system. Numerous special features of the current law, adopted over the years, have led to extreme complexity and have raised questions about the law's basic fairness. Many provisions of the code area, in effect, subsidies to certain types of taxpayers, or to consumption. These subsidies are rarely justified explicitly and, in some cases, may even be unintentional. In many instances, they alter the pattern of economic activity in ways that lower the value of total economic output. Further . . . the tax code does not reflect any consistent philosophy about the objectives of the system."

In short, we need a tax system that looks like it was designed on purpose; a system the American people can not only understand, but one which they will support because it is equitable.

Since then, however, runaway deficit spending and reckless tax increases have driven taxpayers to the brink of revolt.

There are several proposals being considered by this committee. In my opinion the best alternative, is the flat tax. There are about a dozen flat tax models that have been introduced, and I believe that Americans are now ready to take a serious look at these models, come up with the best form and put it into effect.

The dispute that arises over the adoption of a flat rate tax ultimately involves a discourse on the benefits or disadvantages of such a system over the progressive system currently in operation. There appears to be a general consensus among various political and economic experts that the severely progressive system of today is grossly inefficient and detrimental to the economy. However, even with such a consensus, agreement on a system of taxation that would replace the current one has not been swift in coming.

The progressive system of taxation and the "ability to pay" principle have been firmly entrenched in our society for decades. The public, in general, continues to believe that those with higher incomes have the ability to contribute more in taxes and should do so. The "ability to pay" principle has modified the original purpose of taxation from one of raising revenue to meet the limited functions of government to a political instrument for changing the individual taxpayer's behavior in order to meet Congressionally-mandated social goals. As a result, the existing tax structure has become a maze of rules and regulations too complicated for the average citizen to follow.

The imposition of a 10% flat rate tax with few deductions will simplify the outrageous complex and inefficient tax system currently in existence and will reduce the amount of taxes paid by every income bracket. It will bring those in the high income brackets back into the system by removing numerous tax shelters. Those who have been participating in the underground economy to avoid rates of taxation will be brought above ground, induced by drastically lower rates. By including an amnesty program, the flat rate tax will encourage those who have never paid their taxes or who are delinquent in payment of their taxes to correct their situations without fear of civil or criminal penalty. Everyone will pay 10% in taxes to the Federal government, regardless of the size of their income. Those earning more will still pay more tax.

The 10% Flat Rate Tax Act (H.R. 200) was formulated with these objectives in mind. Its principle features include:

(1) Exclusions from gross income which includes: (a) Alimony and separate maintenance payments; (b) Scholarship payments and fellowship grants; (c) Social security payments; (d) Social security tax payments withheld in excess of amount prescribed by law; (e) Disability payments; (f) Payments under the Railroad Retirement Act; (g) Retirement benefits to former government employees (the amount from Social Security only); and (h) Interest payments received on bonds issued by states, counties, or municipalities;

(2) Adjusted gross income composed of gross income minus the following deductions: a) Trade and business deductions; b) Trade and business deductions of employees; and c) Expenses relating to income production;

(3) Deductions from adjusted gross income that include: (a) An exemption of $2,000 each for taxpayer, spouse, and each dependent indexed for inflation by multiplying the exemption by the cost-of-living adjustment for the calendar year; (b) Deductions for interest, taxes, and charitable contributions; and (c) Deductions allowed for certain retirement savings.

REVENUE ESTIMATES

The major question asked about H.R. 200 is how much revenue will it produce? Putting aside the philosophical question of whether we are representing the Federal Government to the People or are we representing the People to the Federal Government, this paper attempts to demonstrate the answer in relation to FY 1983 dollars.

A.B. Laffer Associates have calculated the likely economic effects of a flat tax based on the Cobb-Douglas economic model. Implementation of a flat tax, according to Laffer, would augment economic growth for several reasons. First the dramatic reduction in marginal tax rates would increase incentives to work, save, and invest."

Changes in marginal tax rates are important because they change incentives to demand and supply work effort and capital. For example, firms base their decision to employ workers in part on their total cost to the firm. Holding all else equal, the greater the cost to the firm of employing each additional worker, the fewer workers the firm will employ. Conversely, the lower the marginal cost per worker, the more workers the firm hires. For the firm, the decision to employ is based upon gross wages paid, a concept which encompasses all costs borne by the firm.

Workers, on the other hand, care little about the cost to the firm of employing them. Of concern from a worker's standpoint is how much the worker receives for providing work effort, net of all deductions and taxes. Workers concentrate on net wages received. The greater net wages received, the more wiling a worker is to work. Conversely, if net wages received fall, workers will find work effort less attractive and they will do less of it.

The difference between what it costs a firm to employ a worker and what that worker receives net, is the tax wedge. From the standpoint of a single worker, a tax cut has two types of effects. Because a decrease in marginal tax rates lowers the cost to the employer in the form of lower wages paid, clearly firms will employ more workers. On the supply side, a reduction in marginal tax rates raises net wages received. Again, more work effort will be supplied. In sum, tax rate cuts increase the demand for, and the supply of productive factors. In dynamic formulations, as tax rates fall, output growth increases, and vice versa. Regulations, restrictions, and requirements, along with explicit taxes, are all parts of the wedge.

One goal of H.R. 200 would be to hold the percentage of revenue constant with Gross National Product. However, the rewards for incremental work by labor, the employment of additional capital and the more efficient combination of the two will be higher with the flat tax. As a result, more employment output and production would be expected. Economic growth rates would accelerate until these effects are fully incorporated into the economy. Essentially, H.R. 200 can be viewed as a jobs bill.

INCORPORATING THE UNDERGROUND ECONOMY

Estimates for 1981 suggests that the actual amount of income being sheltered, both legally and illegally, amounted to some $531 billion in that year. Given that tax avoidance has been growing at least 50 percent faster than reported income, we can figure on over $700 billion in income going untaxed this year. And these figures do not include the criminal underground economy.

The largest category was that of Legal and Quasi-legal tax shelters, which would be eliminated under FLAT 10 (H.R. 200), account for nearly $120 billion (in FY 1984 dollars) in untaxed income at a 40 percent marginal rate (resulting in a tax loss of $48 billion).

Most of the other income is unreported or under-reported income. The $45 billion of income in tax free municipal bonds is protected by the constitution.

Assuming that much of this income is under-reported due to high marginal rates, a ten percent flat tax rate could substantially reduce these amounts, in addition to the amount of money no longer sheltered. If the flat tax encouraged only half of the $700 billion projected back into the economy then an additional $350 billion would be added to gross personal income.

AMNESTY PROVISION AND SHORTFALL CONTINGENCY

The FLAT 10 contains a provision which allows for a three year amnesty for taxpayers from criminal and civil penalties if they pay their back taxes. Estimates of the size of the underground economy vary, with figures ranging from $250 billion to over $1 trillion. It is estimate that between $600 billion and $700 billion have been lost in the last five years alone:

The Commonwealth of Massachusetts recently held a tax amnesty for three months. The State estimated that they had a tax gap of some $500 million (tax gap being the amount of revenue that had not been collected due to non-compliance). As of April, the tax commission had received nearly $70 million dollars, or 14 percent of the entire tax gap.

If the United States held a similar amnesty for three years, as envisioned by FLAT 10 a 14 percent estimate for back taxes paid would be conservative, since the U.S. plan would be 12 times longer. If however, the amount was only 14 percent on the $671.3 billion in revenue estimated to have been lost between 1979 and 1983, the amount of additional revenue would be $93.9 billion.

FLAT 10 provides, however, that the amount generated by the amnesty would go into a trust fund which would be used to offset revenue shortfalls that might occur. That means that even though $1,189.9 billion might be raised over the three year amnesty only the portion of that needed to offset projected revenue shortfalls would be expended, used, and the remainder would stay in the trust fund for future shortfalls. In this way FLAT 10 does not result in an inadvertent tax increase unless it occurs through the individual tax itself.

FLAT 10 establishes a trust fund for the deposit of all revenues raised through the amnesty. These revenues would be used to offset any revenue loss created by the implementation of the flat tax. Allowing for a 6 percent growth in the amount of income hidden in the underground economy (a very low amount), the nominal dollar figure for 1985-1989 would be $1,189.9 billion.

INCORPORATION OF THE UNDERGROUND ECONOMY

According to an article in the April 1984 issue of Gentlemans Quarterly magazine by Michael Evans, "the amount collected by the Federal government represents less than 40 percent of the total amount of taxes that would be collected if there were no deductions, no loopholes, no tax cheating."

Estimates for 1981 suggests that the actual amount of income being sheltered, both legally and illegally, amounted to some $531 billion in that year. That would mean about $164 billion in uncollected taxes. Given that tax avoidance has been growing at least 50 percent faster than reported income, we can figure on over $700 billion in income going untaxed this year and $200 billion in taxes passed up. And these figures do not include the criminal underground economy.

The largest category Mr. Evans disclosed was that of Legal and Quasi-legal tax shelters, which would be eliminated under H.R. 200, account for nearly $120 billion (in fiscal year 1984 dollars) in untaxed income at a 40 percent marginal rate (resulting in a tax loss of $48 billion).

Most of the other income is unreported or under-reported income. The $45 billion of income in tax free municipal bonds is protected by the constitution.

Assuming that much of this income is under-reported due to high marginal rates, a ten percent flat tax rate could substantially reduce these amounts, in addition to the amount of money no longer sheltered. If the flat tax encourage only half of the $700 billion projected back into the economy then an additional $35.04 billion. That in addition to the $206.9 billion raised under the Laffer model would result in total revenue of $241.94 (a shortfall of only $46.06 billion, before the amnesty provision and effects on outlays are taken into account).

It should be noted that taxpayers will not have to spend the $60 billion currently spent each year on the preparation of 1040 forms. This money, applied towards productive investments such as housing or automobiles could create hundreds of thousands of jobs, which, or course, increases revenues and lowers outlays.

EFFECTS ON OUTLAYS

There are several positive effects that H.R. 200 would have on the deficit. "Rule-of-thumb" estimates by the Office of Management and Budget say that for every 1 percent decrease in the unemployment rate the deficit should be reduced by $20 billion in outlays, nearly 30 billion when revenues are considered. Thus it is likely that the deficit could be decreased substantially through the acceleration of economic growth and employment likely to be brought on by passage of H.R. 200.

Another positive effect would be a tremendous reduction in government paperwork. It is estimated that over half of government paperwork goes towards policing the tax code. Literally billions of dollars could be saved by the resulting reduction in the federal bureaucracy.

It is probable that in addition to the revenue generated by H.R. 200 that Federal outlays would be reduced by at least $5 billion, thus contributing towards a reduction in the deficit.

DYNAMIC GROWTH EFFECT

There are several ways to calculate the revenue estimate for the FLAT 10, yet many of them would be useless and inaccurate as soon as they were written. For instance, calculating the revenue estimate on a static basis (not accounting for any change in economic patterns) simply does not reflect likely economic activity. A.B. Laffer Associates have calculated the likely economic effects of a flat tax based on the Cobb-Douglas economic model.

The model used to measure economic growth under the flat tax was a simple general equilibrium model for the economy. A range of responses to lower marginal tax rates for capital, high-skilled and low-skilled labor were taken from economic literature. The more responsible economic agents are to the change in tax rates, the greater will be the economic growth effects of implementing a flat tax.

A series of forecasts were made based on different assumptions as to the responsiveness of the economy to the reduction in marginal rates implied by a flat tax. Based on parameters near the low end of the spectrum, the level of GNP would be expected to increase by approximately 8 percent in 1989 and 4 percent in 1990. If, however, the responsiveness of capital and labor to lower tax rates were at the values most economists consider to be at the high end of the spectrum, implementation of the FLAT 10 would elevate real GNP by approximately 15 percent.

[See following tables:]

CALCULATION OF REVENUE ESTIMATE FOR 1989–90

(Figures in billions)

	1989	1990
Static 1989 gross personal income (at current levels)	$4,235.6	$4,536.2
Projection of GPI with low range dynamic effect of 8 percent on GNP	$4,606.8	
1990 with 4 percent dynamic effect		$5,072.1
Projection of underground income (as stated previously)	$350.0	$375.0
Total GPI	$4,956.9	$5,447.1
1989 personal exemption deduction	$466.3	
1990 personal exemption based on 0.85 population growth and 3.3 percent increase in C.P.I		$485.7
Charitable contributions	$55.6	$59.5
Interest payments	$116.7	$124.9
State and local taxes	$71.5	$76.6
IRA and Keough contributions	$50.2	$53.7
Total adjusted gross income	$4,196.6	$4,646.7
Flat Tax (percent)	10	10
Estimated revenue	$419.6	$464.7
Comparison to current system		
CBO individual income projections	$471.0	$515.0
Siljander flat tax proposal	$419.6	$464.7
Revenue shortfall	(– $51.4)	(– $50.3)

Revenue effects including amnesty of the flat 10 percent tax

[In billions of dollars]

Amount of money in Amnesty Trust Fund	$166.5
1989 estimated revenue shortfall	(– 51.4)
Amount from Amnesty Trust Fund	+ 51.4
Revenue shortfall	0.0
Amount remaining in trust fund	115.2
1990 estimated revenue shortfall	(– 53.7)
Amount from Amnesty Trust Fund	+ 50.3
Revenue shortfall	0.0
Amount remaining in tust fund	64.9

FAIRNESS

Many opponents of a flat tax have expressed their concern for its effect at lower income levels. The opposite is true. The Ten Percent Flat Tax would actually aid the poor by doubing the personal exemption from $1,000 to $2,000. This exemption would mean that a worker with a family of four would be able to earn nearly three thousand dollars more under H.R. 200 than under the present system before being taxed. In addition, the personal exemption in the bill is indexed to the rate of inflation, protecting the worker poor from the "most cruel tax of all" as President Reagan says. In addition, the deductions allowed in the bill are those most commonly used by lower and middle income families and lend the greatest assistance to those seeking upword mobility. Also, since lower and middle income heads of households are those most likely to hold a second job the flat tax assists them since their second income would not be taxed at higher marginal rates.

H.R. 200 also assists the elderly, since Social Security and other federal retirement programs are excluded from gross income. Retirees will find much of their income exempt from taxation, and be protected from bracket creep by the flat rate and the indexation of the personal exemption.

I was extremely gratified by a response from a Legal Services attorney in Harrison, Arkansas. In her letter she said, "A 10% flat tax would be one of the best things that ever happened for poor people."

CAN THE CONGRESS RAISE THE FLAT RATE?

The answer is yes. Congress would have the power to raise the rate above ten percent. There are inward political controls to prevent this, but additonal legislative safeguards are needed. The political control against the raising of the rate is that the ten percent figure is that people can accept for different reasons. First it is the same as the biblical tithe. I have often asked people, "If God requires ten percent, does Ceaser have a right to ask anymore?" Secondly, since all people would be taxed at the same rate any attempt to change it would affect all taxpayers, not just a few selected interest groups as the 1982 and 1984 tax bills have done.

The Congress or two-thirds of the states must also pass a Balanced Budget/Tax Limitation Constitutional amendment. The amendment introduced by Congressman Conable in the House would require a three-fifths vote for any tax increase. In addition, the spending restraint imposed by the amendment would halt pressure to increase taxes.

H.R. 200 has a three year phase-in which would give the government time to adjust to the new revenue scheme. During this time the Federal government should freeze its budget. Recently the Senate defeated such an attempt at spending discipline, but the passage of H.R. 200 would demand prompt government restraint. The Grace Commission has demonstrated that billions of dollars can be cut from the federal budget through management improvements.

SUMMARY AND CONCLUSION

Recently former Secretary of the Treasury William Simon made a statement regarding the Ten Percent Flat Tax. In it he said:

"The adoption of a flat rate income tax would result in the elimination of most of the thousands of IRS income tax regulations, and the reduction of the IRS budget and staff. Raising the percentage of a low, flat rate income tax would be difficult politically, as it would affect all taxpayers and would be met with nationwide opposition.

Adoption of a flat rate income tax by Congress will not be an easy task. Congressmen, special interest groups, and those in favor of increased government spending and the redistribution of income will oppose a flat rate tax because it would put an end to the government's limitless ability to spend.

A flat rate income tax will offer the taxpayer relief from the arbitrary, unfair, and inefficient graduated income tax. A low rate, such as 10% would put needed pressure on Congress to curb its continued increases in spending and assist the Federal government in achieving a balanced budget. It would replace the graduated system which misallocates resources and capital with a system that allocates efficiently, without the distortions caused by a manipulative structure of shelters, credits, and deductions. The imposition of a flat rate income tax, correctly constructed, would provide a tremendous stimulus to the American economy."

The American people have given generously of their earnings to others through the tax dollars. It is time that the Congress give the taypayers a tax system that is simple and fair. If Congress cannot accomplish this goal in the face of special interest groups then it is inviting for the second time in America's history a revolution over taxation without "adequate" representation.

Mr. **Flippo** [presiding]. Mark, thank you for your testimony. It is obvious that the way you treat transition issues and the way you address the underground economy and the amnesty provisions are unique and that you are trying to design a tax system that was designed on purpose. I am sure that your effort will make a huge contribution to the delibertations. Mr. Crane?

Mr. **Crane**. Thank you, Mr. Chairman. I want to congratulate my colleague, too. He and I have discussed his tax bill and the only reservation as I have indicated to him that I have is preservation of any deductions, exemptions or exclusions. Not because they are not defensible. We built all of those into the code to achieve certain socially desirable objectives and we figured that working through incentives of the tax system was preferable to creating Government programs to try and address some of those problems.

But I think the most important ingredient of your proposal, Mark, is rejection of the concept of progressivity, and that was a social theory upon which a tax system was created. I don't think anyone can demonstrate anywhere the efficacy of such a code in providing the maximization of incentives for people to get out and be productive and I don't think you can argue the case in moral terms either.

Politically, you know, we have got a tough row to hoe as far as getting acceptance of the idea of a proportional tax, but I want to congratulate you for your tireless efforts to get out and market the concept and I would agree with our colleague, Jack Kemp, when he said that it is largely those efforts in behalf of the flat tax that have made serious consideration of some reforms in lowering the marginal rates even a matter that can be discussed today.

So, you are to be saluted for your efforts. One thing I would like to ask you and that is do you agree with the proposition that businesses do not pay taxes?

Mr. SILJANDER. Well, if the gentleman from Illinois refers to the fact that businesses simply pass taxes onto the products that the consumers purchase, certainly conceptually I agree with that premise.

Mr. CRANE. And second, that that then constitutes not a progressive tax, but a regressive tax?

Mr. SILJANDER. Certainly. It is a regressive tax, especially to the consumer, that purchase various products produced by various manufacturers.

Mr. CRANE. And in that sense then, it is not dissimilar from imposition of a sales tax and the burden of a sales tax without exceptions as are generally provided falls most heavily on those who can least afford to pay it. I don't believe in progressivity, but I'll tell you if you want to debate the case of the moral defensibility of progressivity over regressivity, progressivity certainly wins hands down.

Something it seems to me that we ought to examine is the idea of maintaining the fiction that somehow we are going to protect the little guy and go after those malefactors of great wealth, the giant corporations, and take it out of their hide because they do have to factor it in as a cost, as you say. It has to be passed on just like the labor cost is passed on and plant and equipment costs are passed on, and they are passed on in the least defensible way of any kind of tax system that one could conjure up.

So, hopefully we can maybe in hammering out our proposed tax reforms here, not only accept the idea of proportionality in your proposal, but we could extend this a little further and eliminate the fiction that businesses do pay taxes and only tax earnings and I like the proposals that you have advanced here in this regard.

I simply salute you for all your efforts. Keep up the good work. I'm less pessimistic that we will not get a modified version—well, a so-called modified version of the flat tax. I would say a modified version of a progressive income tax, and I think because of the general awareness, growing awareness of what is really involved in proportional taxation that we have a chance to do something really significant and when we do, the historians are going to go back and carve out a big chapter for Mark Siljander.

Mr. SILJANDER. Well, I appreciate the gentleman from Illinois and his kind comments and the emphasis that this is a national movement. There are literally, and I'll repeat, millions of Americans who are demanding a lower tax rate, demanding to be unbound with the rules and regulations of the Tax Code and who are crying out for help and assistance. And there are those in the underground economy who are pleading for an opportunity without long jail sentences and stiff penalties of a slight incentive to boost them out of the underground which has worked in Massachusetts and nine other States are now beginning that type of approach. There are 9 or 10 various proposals. All but one, I think, are Republican, and the Siljander approach does have by far more Republican cosponsors than any other proposal in the Congress and growing each and every day.

So, there is a movement internally in Congress, Mr. Chairman, as well as outside, that the Siljander approach, at least conceptually, be considered with the 3-year, phase-in period, the amnesty, and some basic deductions. From a practical point of view, we believe it is time to give this dynamic effect of reducing tax rates a chance to work.

I argue that ours is the only approach that eliminates that risk factor and can truly experiment with a dynamic form of tax reduction.

Mr. CRANE. I agree with you and I congratulate you on your call for the amnesty, because I think that has to be tied into your kind of proposal and it would spare a lot of grief in this country, a lot of wasted wheel-spinning exercise by Government bureaucrats, too. Thank you.

Mr. FLIPPO. Thank you very much for your testimony.

Our next witnesses, we will have a panel, Hon. William Roth, Jr., the distinguished Senator from Delaware, and our own colleague, Henson Moore of Louisiana, and I might say, Senator Roth, we apologize. We realize you have been here for some time and apologize for the delay.

Please present your testimony in anyway you deem appropriate.

STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM THE STATE OF DELAWARE

Senator ROTH. Well, thank you very much, Mr. Chairman. Being a chairman of a committee myself, I understand that things never go quite as one would plan, but I do want to congratulate you and the committee for holding these hearings.

We appreciate the opportunity to discuss the tax reform plan that your distinguished committee and colleague, Henson Moore and I have introduced, what we call the Broad Based Enhanced Savings Tax Act, or BEST.

Now, let me start out by saying, Mr. Chairman, that BEST is not just a fancy PR gimmick to turn a sow's ear into a silk purse. We do believe we have the best plan, because it is the only tax plan that has been put forth that satisfies what I think are the four critical goals of any tax reform.

We believe that we need a new tax system that is fair, simple to understand, simple to enforce. Two, it is revenue neutral, both in relation to the current law and does not alter the distribution of the tax burden by income class.

Three, reduce marginal tax rates in order to maximize the incentives to work and save. Fourth, and what I think is most important and has not been talked about long enough to insure the Nation's long-term economic growth and health by providing incentives for savings and investment, the chief source of capital for industrial growth, modernization and jobs. The last point, Mr. Chairman, separates the Roth-Moore plan from any other now proposed.

I want to congratulate my colleagues for their plans. I think that the tax reform is an idea whose time has come, an idea that enjoys substantial support across party lines. But frankly, I don't think the Congress should endure the agony of rewriting the entire Tax Code unless—unless we can add substantially to the savings and investment rate in this country.

Our Tax Code should be more than just a vehicle to collect money. It should be a blueprint for economic growth by helping create the environment that makes growth possible. I think we took a giant step back in 1981 when we reduced taxes on both individuals and businesses. I'm proud that my name is linked to that act, because I think the tremendous expansion that has occurred in our economy since then is directly related to that law.

The chairman of this committee and other members should take pride in writing and passing that landmark measure. Now, in 1985 we can build on this legislation and further improve the economic climate of our Nation through tax reform, but to succeed in doing this, any reform must include major inducements for increased savings.

Let me just briefly discuss the major features of the Roth-Moore bill. Our plan eliminates virtually all the existing exemptions, deductions, and credits. The only exceptions would be home mortgage interest, a deduction for charitable contributions, a deduction to protect against catastrophic medical expenses.

In addition, legitimate business expense for a personal business would, of course, remain deductible. In order to assure that no one below the poverty line is taxed, our plan, like the others, would expand the substantial zero bracket plan and retain personal exemptions.

The earned income credit would be expanded beyond that of current law. We create only four tax brackets, 12 percent, 20, 30, and a maximum of 34.

Now, Mr. Chairman, the centerpiece of our bill and what makes our plan different and better is the creation of a super savings account or SUSA. The SUSA would function much like the current IRA, except that savings could be for any purpose, not just retirement, and the funds could be withdrawn at any time without penalty.

Net contributions for a SUSA would be tax deductible up to $10,000 for an individual, $20,000 for joint returns per year. Existing IRA's would be retained, but subject to the overall SUSA limit. Our plan would retain existing Keogh plans as a separate entity not covered by SUSA limit.

Also, we would replace the complicated system of capital recovery provisions and credits for equipment with immediate expensing.

Now, Mr. Chairman, the plain and simple fact is that our tax system contains an inherent bias against savings through double taxation. Savings is done out of after tax dollars and then income from savings is taxed at high rates. The lack of neutrality between the tax treatment of savings and consumption is one reason our savings rate is so low. The issue of saving rate is not some esoteric matter best left to economic tomes.

Frankly, it is directly related to our ability or inability to compete in the world economy. Let me just for a minute compare our poor to mediocre experience with the Japanese, our primary economic competitors.

Since 1976 the U.S. savings has hovered at around 6 percent and would have been lower due to the recession were it not for the fact that the IRA's created much new savings. By contrast, Japan, whose government provides substantial savings incentive has a savings rate in excess of 20 percent over the same period. It's a combination of various saving incentive plans and Japanese law that has effectively removed the double taxation of saving in Japan.

The Japanese agree that it is their tax incentive for savings that cause their people to save so much. They have been successful in their savings incentive programs that a nation of 100 million people has almost 200 million savings accounts. It would seem there are some illegal tax shelters there perhaps, Mr. Chairman. But, in any event, it is this savings pool which drives the incredible investment and growth in Japan.

Is it any wonder that they are outproducing us in so many critical areas? Nakasone, in a recent meeting, told me that it was a steady source of capital provided by the individual savings system that makes them so competitive in the world today; and frankly, Mr. Chairman, I see real trouble ahead for this country in its efforts to compete in tomorrow's world unless we start today in seeking ways to generate greater savings from our people.

The nations who are going to emerge as the industrial leaders of tomorrow and who will provide jobs to their citizens will be those who have insured that their industrial facilities are the most modern in the world. If we are to remain one of the world economic leaders, then it is important that we develop a continuing fresh supply of domestic capital through savings to make that happen.

Mr. Chairman, I'd just like to point out that last Sunday in the New York Times there was a major article on high technology where it says the United States is losing ground in economics. Why? Partly because our plants are not as modern and the reason our plants are not as modern is that our capital is more expensive than it is in Japan.

I think this is a lesson that we should have learned with our smokestack industries and that we must face in the future. Now, commonsense tells me that if we lower the tax penalties on savings, people will save more; and if you don't like the commonsense argument, then there are plenty of studies that indicate savings are quite responsive to tax treatment.

Finally, we only have to consider the incredible phenomenon of IRA's to understand what favorable tax treatment of savings can do. IRA is a middle-class savings tool. The Congressional Research Service says that 78 percent of the returns reporting IRA's have incomes under $50,000. People between $10,000 and $20,000 in income put over $3 billion in IRA in 1982, the year of the study.

We can build upon the success and promise of IRA's through the SUSA, which, frankly, is nothing but a super IRA, super for the saver and super for the country.

Mr. Chairman, the reform will be a long, difficult, agonizing process even with the bipartisanship that has been shown to date. Let us ensure that when we get at the end of the road that we have done something more than make a lot of tax lawyers and lobbyists rich. Let's ensure that the savings base, the engine of growth and jobs in this country, is substantially expanded. We believe the Roth-Moore BEST plan accomplishes tbe goal of tax reform, fairness, and simplicity, while providing a powerful tool for investment and jobs.

Mr. Chairman, I would urge your favorable consideration of its concept, and I am particularly pleased at this stage to ask Henson Moore, who has been coauthor and such a leading light in the area of tax reform for his comments.

[The prepared statement follows:]

STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM THE STATE OF DELAWARE

Mr. Chairman, thank you very much for the opportunity to appear before you to discuss the tax reform plan that your distinguished committee colleague, Rep. Henson Moore, and I have introduced—the Broad-Based Enhanced Savings Tax Act, or "BEST".

First, let me say that the moniker "BEST" is not just some fancy PR device to turn a sow's ear into a silk purse. We believe that we have the best plan, because it is the only tax plan that has been put forth that satisfies what I believe are the four critical reasons why tax reform is necessary. We need a new tax system that

1. Is fair, and simple to understand and enforce;
2. Is revenue-neutral in relation to current law, and does not alter the distribution of the tax burden by income class;
3. Reduces marginal tax rates in order to maximize the incentives to work and save; and, most importantly
4. Insures the nation's long-term economic growth and health by providing incentives for savings and investment—the chief source of capital for industrial growth and modernization and jobs.

That last point, Mr. Chairman, separates the Roth-Moore plan from any other plan now proposed. I want to commend Senators Bradley and Kasten, and Representatives Gephardt and Kemp, as well as the Administration, for their plans. I think that tax reform is an idea whose time has come, and an idea that enjoys substantial support across party lines. But frankly, I don't think that Congress should endure the agony of re-writing the entire tax code unless we can add substantially to the savings and investment rate in this country.

Our tax code should be more than just a vehicle to collect money. It also should be the blueprint for economic growth by helping create the environment that makes that growth possible.

We took a giant step in improving that growth environment back in 1981 when we reduced taxes on both individuals and businesses. I am proud that my name was linked to that act, because I think the tremendous expansion that has occurred in our economy since then is directly related to that law. The Chairman of this committee and its other members should take just pride in writing and passing this landmark measure.

In 1985, we can build on this legislation and further improve the economic climate of our nation through tax reform. But to succeed in doing this, any reform must include major inducements for increased savings.

Let me briefly describe the major features of the Roth-Moore bill. Our legislation eliminates virtually all the existing exemptions, deductions and credits. The only exceptions would be the home mortgage interest deduction, a deduction for charitable contributions, and a deduction to protect against catastrophic medical expenses. In addition, legitimate business expenses for a personal business remain deductible.

In order to insure that no one below the poverty line is taxed, the system would expand the substantial zero bracket amount and retain personal exemptions. The earned income credit would also be expanded beyond that of current law.

We create only four tax brackets—12%, 20%, 30% and a maximum rate of 34%.

The centerpiece of our bill, however, and what makes our plan different and better, is the creation of "super savings accounts", or SUSA's. The SUSA would function much like the current IRA's, except that savings could be for any purpose, not just retirement, and the funds could also be withdrawn at any time without penalty.

Net contributions to a SUSA would be tax deductible, up to $10,000 for an individual and $20,000 for joint returns, per year. Existing IRA's would be retained but subject to the overall SUSA limit. Our plan would retain existing Keogh Plans as a separate entity not covered by SUSA limits.

Also, we replace the complicated system of capital recovery provisions and credits for equipment with immediate expensing. This is crucial to our goal of creating an environment for investment.

Mr. Chairman, the plain and simple fact is that our tax system contains an inherent bias against savings through double taxation. Saving is done out of after-tax dollars and then income from savings is taxed at high rates. This lack of neutrality between the tax treatment of savings and comsumption is one reason our saving rate is so low.

The issue of savings rates is not some esoteric matter best left to economic tomes. It is directly related to our ability—or inability—to compete in the world. Let me for a moment compare our poor to mediocre experience with the Japanese, our primary economic competitor.

Since 1976, the U.S. savings rate has hovered at around 6 percent, and would have been lower due to the recession were it not for the fact that IRAs created much new savings. By contrast, Japan, whose government provides substantial savings incentives, has a savings rate in excess of 20% over the same period. The combination of various savings incentive plans in Japanese law has effectively removed the double taxation of saving in Japan. The Japanese agree that it is their tax incentives for savings that cause their people to save so much. They have been so successful in their savings incentive program that a nation of 100 million people has about 200 million savings accounts. And it is this savings pool which drives the incredible investment and growth in Japan. Is it any wonder that they are out-producing us in so many critical areas?

Prime Minister Nakasone himself told me, in a recent meeting in Tokyo, that it was the steady source of capital provided by the Japanese saving system that makes them so competitive in the world today. Frankly, Mr. Chairman, I see real trouble ahead for this country in its efforts to compete in tomorrow's world unless we start today in seeking ways to generate greater savings from our people.

The nations who are going to emerge as the industrial leaders of tomorrow, and who will provide jobs to their citizens, will be those who have insured that their industrial facilities are the most modern in the world. If we are to remain one of those world economic leaders, then we must develop a continuing fresh supply of domestic capital through savings to make that happen.

Common sense tells me that if we lower the tax penalties on saving, people will save more.

And if you don't like the common sense argument, then I can point to plenty of studies that indicate savings are quite responsive to tax treatment.

Finally, we only have to consider the incredible phenomenon of IRAs to understand what favorable tax treatment of savings can do. The IRA is a middle-class savings tool. The Congressional Research Service says that 78% of the returns reporting IRAs have incomes under $50,000. People between $10-20,000 in income put over $3 billion in IRAs in 1982, the year of that CRS study. We can build upon the success and the promise of IRAs through the SUSA, which frankly is nothing more than a super-IRA—super for the saver and super for the country!

Tax reform will be a long, difficult, agonizing process, even with the bipartisanship that has been shown to date. Let us ensure that when we get to the end of the road, we will have done something more than make a lot of tax lawyers and lobbyists rich. Let's ensure that the savings base, the engine of growth and jobs in this country, is substantially expanded.

The Roth-Moore "BEST" plan accomplishes the goals of tax reform—fairness and simplicity—while providing a powerful tool for investment and jobs. I urge your favorable consideration of its concepts.

STATEMENT OF HON. W. HENSON MOORE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. Moore. Thank you, Senator and Mr. Chairman. I want to thank the Senator for this time last year asking me to join with him in this project. It is something that he had been working on for a long time before me. I was very pleased to join with him and I think we do have the best plan.

All of the other tax proposals concern me in one major regard. What does it do on the aggregate amount of capital being saved and invested in this country? If it does nothing, like the Senator says, we have missed an opportunity. If it does something to harm it, we are making a mistake.

This is the only proposal that I am aware of that concretely shows an increase in aggregate savings in this country.

The second point I would make is the fact that right now we are consuming, according to the latest figures, 60 percent of all of the private savings in this country to finance our deficits, as compared to a 25-percent historic level. We are over double because of the big deficits we are running.

The only reason that interest rates aren't higher than they are and their real level is high enough; as a matter of fact, some say historically high, the only reason they aren't higher still is because of the foreign capital that is in this country right now financing that deficit. Should that foreign capital begin to drain away, we must expect that it just may go to a better market than this one at some point in the future, then you will see interest rates go through the ceiling as we see the impact of the Federal Government borrowing 60 percent instead of 25 of all of the capital in this country.

The third point I would make is the fact that in hearings here, as the Senator said, and I remember asking a number of witnesses several years ago, including the chairman of the Federal Reserve System, isn't it unique? Isn't it backward that we have a disincentive for savings, such as double taxation that the Senator mentioned, yet we give everybody a tax deduction for spending money they don't have and borrowing it, the interest deduction? It's just backward. The system ought to work the other way to encourage savings.

If you looked at it from the point of view of economics, every additional dollar of savings that you have offsets a dollar of that deficit. We can bring the deficit down by reducing the spending. Certainly I support that. We could even do it by raising the taxes. I don't support that.

We can also do it by increasing the savings rate. Every additional dollar we save offsets the pressure on interest rates of a dollar of spending.

The IRA changes that Senator John Chaffee and I cosponsored in 1981 and is now law has improved what we are saving and what the BEST bill shows, that this would, in fact, bring about an increase in savings. It works. A new report just out several days ago by the Investment Company Institute now pegs the additional savings in 1983 due to IRA changes that we made in 1981, the net figure of $10 billion additional savings that would not have been saved absent these provisions.

As late as last year, 23 million American households had opened an IRA. Two-thirds of those had incomes of under $40,000 a year. IRA assets were $26 billion at the beginning of 1982 when the changes we passed in 1981 became law and they are now running at the end of last year $132 billion are now in IRA's.

The public out there is telling us that we have got a good idea. It works, and they will save but the figures we are seeing now, look what we would do if we made some changes like we are suggesting in this bill. While 23 million American households now have an IRA, according to the survey I just referred to, 5 million more would open one if full spousal eligibility would occur, as we are proposing; 6 million more would open one if we had a matching nondeductible additions allowed; and 19 million households more would open one if withdrawals could be made at any point without the 10-percent tax penalty we now have in the law.

It seems to me the figures have shown it. We tried it in 1981 and it is working. The people out there are telling us it is working, and they are telling us that if we will make changes like we are talking about, many times more Americans will open IRA's or will save money as we are talking about now.

Increasing the limits to $10,000 as the BEST proposal asks us to do, doing away with the early withdrawal penalty will see to it that we increase savings in this country by a tremendous amount.

Therefore, I strongly urge this bill be given very serious consideration as we address the uniqueness that the other bills have missed.

[The prepared statement follows:]

STATEMENT OF HON. W. HENSON MOORE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. Chairman and my colleagues, Senator Roth and I have chosen introduction of a tax simplification format having a substantial incentive for long-term saving formation as it is the genesis of capital formation we will need to have to sustain economic growth for years to come. Our framework, like others, observes revenue neutrality with the current tax system and many base-broadening and rate reduction components are similar with other formats as well. But it is the economic capacity to satisfy investment demands as we look to the future that is our paramount concern. We do not want to see economic growth fail to mature or die on the vine because of a drought in available capital. We look to savings formation to nurture economic growth to capacity.

In constructing a device for savings formation, we wanted something with broad public appeal and recognition that would do its intended job. The Individual Retirement Account came closest to meeting these requirements in our judgment. A few days ago the Investment Company Institute released findings that the IRA added $10 billion to savings deposits in 1983 that otherwise would have been spent. By late last year, 23 million households had opened an IRA. Nearly two-thirds of these had household incomes under $40,000 a year. IRA assets climbed from $26 billion at the start of 1982 when nearly everyone with earned income became eligible for these plans, to $132 billion at the end of 1984. These are strong signals that the IRA is doing its intended job.

Then we asked ourselves if we could modify the IRA to do an even better job. Here again, the Investment Company Institute findings agree with the direction of our improvements in building a super savings account as the focal point of our simplification format. While 23 million households now have an IRA, households it surveyed indicated 5 million more would open one if full spousal eligibility would occur, 6 million would open one if matching nondeductible additions would be allowed, and 19 million households would open one if withdrawals could be made at any point with the only tax consequence being treatment as ordinary income at the highest marginal rate the taxpayer would pay. The super-savings account will motivate these nonparticipating households to establish do-it-yourself retirement and savings protection. It broadens the base of savings formation.

This is why we retained IRA investment diversity, increased deductible limits to $10,000, and removed the lack of access barrier to present in the current IRA early withdrawal penalty. Young survey respondents found the penalty waiver an especially strong motivating force to open an account.

We must not permit Federal deficits to ration many credit users out of capital markets. Federal borrowing consumes approximately 60% of available capital now compared to historic levels of 25%. Foreign debt investment here has abated the severity of a credit crunch to date, but foreign investment can take flight as fast as a new opportunity arises elsewhere disrupting capital markets as debt refinancing consumes even larger bites of a shrinking supply of available capital.

We must protect ourselves against such an occurance. Private sector pension funds provide such stability and the IRA device possesses the greatest potential among these due to its having the broadest base of eligible participants. Private-sector pension funds have grown to be the single largest source of investment funds accounting for 27% of all assets held by institutional investors in 1981. Due to spectacular IRA growth since then, the purpose of captial formation continues to be served. Pension investments accounted for nearly a third of new funds committed to venture capital in 1982.

Savings formation assures capital formation to satisfy Federal debt financing and private sector credit needs if there is ample reason to save. Senator Roth and I believe our tax format favors the type of capital formation necessary to sustain fully functioning economic growth for years to come.

Mr. FLIPPO. Thank you very much for your testimony. There is much attractiveness about the proposal that you make to encourage savings. There is one particular area I wonder if you would elaborate on.

Would you permit funds to be borrowed and deposited in the IRA and take a tax deduction on the interest?

Senator ROTH. No, actually there is in the legislation a specific prohibition for doing that. Actually that would be avoiding the true purpose of the legislation.

Mr. FLIPPO. I see. So you would have a limitation that would prevent that?

Senator ROTH. That's correct.

Mr. FLIPPO. Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman, and I, too, want to welcome our distinguished colleagues before the committee. As you indicated, Senator Roth, in your testimony, the centerpiece of your bill is this super savings account and I want to salute you for that contribution to our total discussion of tax reform and I also want to salute our colleague on this committee for his very active role in promoting IRA's.

I, too, share your concern about a Tax Code that is now really 50 years old, that specifically punished people for saving in this country. Every one of us was brought up by our parents and we attempt to indoctrinate our children in the idea that you should work and put away for a rainy day, and then, as Henson pointed out, we punish you for that, but we will reward you for going into personal debt.

Back as recently as 4 or 5 years ago, the Japanese were running deficits that were larger as a percentage of their GNP than we were running and they were financing them at approximately 6½-

percent interest rates because of that enormous pool of capital that was the result of for all practical purposes not taxing savings.

Frankly, I would go further even than you have proposed here. I don't favor taxation of any interest. People should be rewarded for doing that and you already paid taxes when you earned the money. Why do we go back and clobber that same hard earned dollar a second time?

We've got more eccentricities in the code, too. So long as we preserve the estate and gift taxes in our Tax Code, and they haven't been totally eliminated, but on principle you are going after that same dollar yet one more time and punishing that conscientious hard working citizen for having the audacity to die and thus deny the biggest interest group of all, the Federal Government, the prospective earnings of that hard working citizen and batter his bereaved widow and heirs by getting that dollar one more time.

So, I simply want to congratulate you. I think that that has to be a vital ingredient of whatever we do in this area of reform, and while we might debate some of the other aspects, it truly is the centerpiece of your legislation. I salute you for your past efforts and hope that we will give this very profound consideration as we get to any mark up on any major significant alteration of our Tax Code.

Senator ROTH. Thank you.

Mr. FLIPPO. Thank you very much for your presentation. Thank you very much, gentlemen.

Senator ROTH. If I could just close with one statement. I am concerned that in the process of tax reform there are so many controversial matters that it is very easy to overlook what I think, as I've said, is the most important consideration. And that is, how do we build an environment of growth in the private sector, and create the jobs that I think are necessary for the future? I would hope, Mr. Chairman, that you and the others who are here today would insure that we eliminate this discrimination against savings and understand that what we do is of critical importance to the long-term development of this country.

Thank you very much.

Mr. FLIPPO. I appreciate the statement of the Senator, and I might just say to him that the other thing that he didn't elaborate on too much, but is extremely important, is that your proposal would give middle-income Americans some flexibility, some choices to make in the tax area.

If we simply strip off everything, they will be totally exposed to the tax system with no choices left. And I commend the Senator for his—and the Congressman, too.

Senator ROTH. Thank you and we look forward to working with you.

Mr. FLIPPO. Thank you.

Our next witness was supposed to be Hon. Dennis DeConcini, but I believe he is not here. Without objection we will include his written testimony in the record and ask Hon. Bob Kasten, the distinguished Senator from Wisconsin to come forward and to give us the benefit of his testimony.

Thank you very much for being here. We will, of course, include your entire testimony in the record and please feel free to approach the issues you deem appropriate, Senator.

STATEMENT OF HON. ROBERT W. KASTEN, JR., A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator KASTEN. Mr. Chairman, thank you very much for the opportunity to appear before you this afternoon to discuss tax reform. I firmly believe that Congress will adopt and that the President will sign a revenue neutral, bipartisan tax reform measure this year.

Tax reform is something just about every American will benefit from and it is clear that it is about to become a reality. This hearing is an important step toward formulating a tax system that is fairer, simpler, and less of a burden on our Nation's economy and taxpayers.

As this hearing indicates, there is a great deal of interest in tax reform in Washington and all across the country, for years we have heard, all of us have received letters and postcards and heard from constituents expressing their irritation, their dissatisfaction, and just plain anger at our tax system.

The American taxpayers deserve a tax system that is fair, simple, and yet provides incentives for savings, investment, risk taking, and economic growth. It is time for an overhaul of our current tax system and the fair and simple tax will do it.

The Fair and Simple Tax Plan offers the best features of a flat tax, a single rate applied to an expanded tax base, along with special provisions for the working poor, families with children, homeowners, savers, and small businesses.

In brief, Mr. Chairman, the plan caps the tax rate at 24 percent, doubles the personal exemption, provides an employment income credit, and maintains many essential deductions in current law. Many people are concerned that a pure flat tax would eliminate some deductions that most middle-American, middle-income Americans consider absolutely essential.

So, in our proposal we maintain the current tax law treatment of some deductions, such as mortgage and investment interest, charitable contributions, property taxes and ordinary business expenses, pensions and IRA's.

Kemp-Kasten also maintains the current law treatment of Social Security with minor liberalization of the taxation of benefits. But, in keeping with the current treatment of Social Security, we are concerned about the regressive nature of the payroll tax, and to make sure that low- and middle-income taxpayers do not face a tax increase as a result of the interaction between a 24-percent tax rate and the FICA marginal tax rates, we provide an employment income exclusion.

The exclusion allows taxpayers earning less than thir wage base, about $40,000, to exclude 20 percent of their wage and salary income from taxation. This exclusion, along with the higher zero bracket amounts and doubled personal exemptions were to actually lower cases in many cases. The exclusion is phased out for income earned over the wage base.

Many critics have voiced concern that a flat tax would raise taxes on lower income earners. I'm concerned about that too, and so FAST is designed to keep the tax burden facing the low- and middle-income taxpayer the same, if not lower than in current law. This is done by doubling the personal exemptions, increasing the zero bracket amount, and offering the employment income credit.

As a result of this, FAST ends up taking approximately 1.4 million lower income taxpayers off the tax rolls.

There are a number of other attributes of FAST which I would just like to summarize. First, FAST is not biased against the family. In fact, a working family of four would pay no tax on the first $14,125 of income. FAST is fair. Under this plan, no one below the poverty level will pay taxes and this isn't so under current law.

FAST helps millions of Americans get out of the welfare trap. Because of high marginal tax rates, Americans receiving welfare payments now hesitate to take a job for the same amount of money. After paying taxes, they have less than they did before they took the job. Since FAST raises the tax threshold above the poverty level, the choice between working and receiving welfare is avoided.

Mr. Chairman, most of the concerns I hear about tax reform plans are aimed at changes in depreciation writeoffs and capital gains and the charitable deductions. I believe that our proposal has the most favorable treatment of these provisions and I predict that the final tax reform plan, when agreed to by the Treasury and both Houses of Congress will treat these issues very much as the FAST tax plan does.

Specifically, deductions for charitable contributions are allowed for both itemizers and nonitemizers just as in current law. Capital gains are fully taxed at normal rates on the basis of the index for inflation or the taxpayer may choose to exclude 40 percent of net capital gains from tax. So we do maintain a preferential treatment of capital gains.

Depreciation is designed to provide the economic equivalent of expensing. In fact, we retain the current ACRS depreciation classes, but lengthen them slightly and increase to total nominal writeoffs to provide the present value of expensing. The allowances are also indexed for inflation.

The American people deserve a tax break. The American people deserve a break from high tax rates and the American people deserve a break from the complex Tax Code. In fact, a Washington ABC poll done earlier this year, found that 63 percent of the American people favor current efforts to reform and to simplify the Federal Tax Code.

Many of us have been working on a comprehensive reform of the Tax Code. You have had us testifying here before you, the Treasury, Senator Bradley, Congressman Gephardt, Congressman Kemp, myself, and many, many others. The tax reform measures that we have sponsored may have some differences, but overall, they are very much alike, and what is more, they have been gaining significant support around the country. All of us are committed to tax reform, and I hope, Mr. Chairman, that you and your committee have joined us in that commitment and that we will, in fact, be able to develop a fair and simple modified flat tax program that will meet the requirements that all of us seek.

I have, Mr. Chairman, summarized my statement. I'd ask unanimous consent that the entire statement appear in the record as if read.

[The prepared statement follows:]

STATEMENT OF HON. ROBERT W. KASTEN, JR., A U.S. SENATOR FROM THE STATE OF WISCONSIN

Mr Chairman, I am pleased to appear here this afternoon to discuss tax reform. I firmly believe that Congress will adopt—and the President will sign—a revenue neutral bipartisan tax reform measure this year. Tax reform is something just about every American will benefit from, and it's clear that it's about to become a reality

Mr Chairman, you are to be commended for holding this hearing, and for giving everyone a voice in the process of reforming the tax code. As you know, this hearing is especially important since Secretary Baker has been meeting with a number of us in order to put together a bipartisan, revenue neutral tax reform measure. It is my strong hope that by the time we have worked through the legislative process, there will be a Reagan-Baker-Rostenkowski-Kemp-Bradley-Packwood-Kasten-Gephardt plan for tax reform.

This hearing is a very important step toward formulating a tax system that is fairer, simpler, and less of a burden on our Nation's economy and taxpayers. Mr. Chairman, I welcome the chance to testify here today, so that I may outline the Kemp-Kasten modified flat tax, and explain the basic concepts underlying out plan.

My good friend Congressman Jack Kemp and I sponsored the Fair and Simpler Tax Plan [FAST], which we believe will provide the American taxpayers with much needed relief from the current tax system.

As this hearing indicates, there is a great deal of interest in tax reform in Washington—and all across the country. For years, we have all received letters and postcards from constituents expressing their irritation, dissatisfaction, and just plain anger at our tax system. The American taxpayers deserve a tax system that is fair, simple, and yet provides incentives for saving, investment, risk-taking, and economic growth. It's time for an overhaul of our current tax system, and the fair and simple tax will do it.

The Fair and Simple Tax Plan offers the best features of a flat tax—a single tax rate applied to an expanded tax base—with special provisions for the working poor, families with children, homeowners, savers, and small businesses. In brief, the plan caps the tax rate at 24 percent, doubles the personal exemptions, provides an employment income credit, and maintains many essential deductions in current law.

Many people are concerned that a pure flat tax would eliminate some deductions that most middle income Americans consider absolutely essential. And so, in our proposal we maintain the current tax law treatment for some deductions such as mortgage and investment interest, charitable contributions, property taxes, ordinary business expenses, pensions, and IRA's.

Kemp-Kasten Also maintains the current law treatment of Social Security—with minor liberalization of the taxation of benefits. But in keeping the current treatment of Social Security, we were concerned about the regressive nature of the payroll tax. To make sure that low and middle income taxpayers do not face a tax increase as a result of the interaction between the 24 percent tax rate and the FICA marginal tax rates, we provide an employment income exclusion.

The exclusion allows taxpayers earning less than the wage base—about $40,000—to exclude 20 percent of their wage and salary income from taxation. This exclusion coupled with the higher zero bracket amounts and doubled personal exemptions, work to actually lower taxes in many cases. The exclusion is phased out for income earned over the wage base.

Many critics have voiced concern that a flat tax would raise taxes on the lower income earners. I am concerned about that too, and so FAST is designed to keep the tax burden facing the low and middle income taxpayer the same, if not lower than in current law. This is done by doubling the personal exemptions, increasing the zero bracket amount, and offering the employment income credit. As a result of this, FAST ends up taking approximately 1.4 million lower income taxpayers off the tax rolls.

And while Americans in the upper income brackets will have their income tax brackets reduced from 50 to 24 percent, many of the tax preferences they now use to shelter income will no longer be available. The big losers will be those taxpayers who have mastered the art of exploiting the tax code.

Although FAST is designed to be revenue neutral in static terms, we believe that over time the Federal Government will gain more revenue from it. Not only will we see more revenue from a growing economy, but paying a lower tax rate of 24 percent will be more agreeable to upper income Americans than chasing after shelters.

This would be very much like the revenue effect we are now seeing as a result of the reduction in the top tax rate from 70 to 50 percent. Preliminary treasury data shows that taxpayers in the upper income brackets are actually providing more revenue to the treasury.

As a modified flat tax, FAST solves many of the problems inherent in a progressive tax system. Problems such as the marriage penalty for a family with two income earners, the disincentives of increasing marginal tax rates as earnings rise, and bracket creep just do not apply. Many other leading tax proposals do not really address these problems.

There are a number of other attributes of FAST, such as:

FAST is not biased against the family. In fact, a working family of 4 would pay no tax on the first $14,125 of income.

FAST is fair. Under this plan, no one below the poverty level will pay taxes. This isn't so under current tax law.

FAST helps millions of Americans get out of the welfare trap. Because of high marginal tax rates, Americans receiving welfare payments now hesitate to take a job for the same amount of money. After paying taxes, they have less than they did before they took the job. Since FAST raises the tax threshold above the poverty level, the choice between working and receiving welfare is avoided.

On the business side, FAST also provides incentives for work, saving, investment, and business enterprise. The treatment of capital gains is generous. The top corporate rate is dropped from 46 to 35 percent, and the accelerated depreciation system is modified to provide the economic equivalent of expensing.

With FAST, the emphasis is on rewarding profit by taxing it at the lowest possible marginal tax rate. The base is also broadened by eliminating many corporate tax avoidance schemes. On the whole, FAST is designed to provide a more neutral tax system which doesn't target any particular industry, and minimizes tax interference in the free market.

Mr. Chairman, most of the concerns I hear about tax reform plans are aimed at changes in depreciation writeoffs, capital gains, and the charitable deductions. I believe that FAST has the most favorable treatment of these provisions, and I predict that the final tax reform plan will treat these issues very much as FAST does.

Specifically, under FAST:

Deductions for charitable contributions are allowed for both itemizers and nonitemizers—just as in current law.

Capital gains are fully taxed at normal rates and the basis is indexed for inflation. Or, the taxpayer may choose to exclude 40 percent of net capital gains from tax.

Depreciation is designed to provide the economic equivalent of expensing. In FAST, we retain the current ACRS depreciation classes, but lengthen them slightly and increase to total nominal writeoffs to provide the present value of expensing. The allowances are also indexed for inflation.

Mr. Chairman, as important as these issues are to businesses, I believe that tax reform really has more to do with the average American taxpayer. According to the Department of Treasury, only 30 percent of all American taxpayers itemize their deductions. Therefore, special tax preferences—and whether or not they remain as preferences—really don't matter to 70 percent of all taxpayers. Lower tax rates, however, do matter to them.

As Congress passes laws which, in one way or another, exclude large amounts of income from the tax base, higher tax rates must be applied to the remaining income just to break even. Americans that can't use preference items to avoid higher tax rates—and that's about 70 percent of them—must go ahead and pay higher and higher taxes. It isn't fair.

The American taxpayers deserve a break from high tax rates and a complex tax code. In fact, a Washington Post/ABC poll done earlier this year found that 63 percent of the American people favor current efforts to reform and simplify the Federal tax code.

Unfortunately, Americans may never see tax reform, because the special interests in Washington, D.C., are opposed to it. They have a vested interest in keeping the current tax system—and the special deductions, credits, or exclusions that benefit them. The last thing they want to see is tax reform, and they characterize tax reform as just another Federal raid on the wallets of average American taxpayers.

Nearly 5 million people each year—those who are using the most basic forms the IRS has—the 1040A or 1040EZ—go to an accountant or tax specialist to figure out their taxes.

Here we are, just 3 weeks away from the tax filing deadline of April 15th. But, the tax code is such a mass of confusion that nearly 10 million taxpayers filing returns with annual income of less than $10,000 hire a professional tax preparer.

This is wrong. And, this is why many of us have all been working on a comprehensive reform of the tax code. You've had us testifying here before you—the Treasury Department, Senator Bradley, Congressman Gephardt, Congressman Kemp, myself, and many others. The tax reform measures that we have sponsored may have some differences, but overall they are very much alike. And, what's more they have been gaining significant support around the country. We are all committed to tax reforms. I hope, Mr. Chairman, that you and your committee have joined with us in that commitment.

Mr. FLIPPO. Senator, we will certainly include the entire testimony and I want to thank you for your testimony and your contribution to this debate.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman. I want to thank you, too, Senator, for all the effort and time that you have expended on this very, very important subject, but have you done an analyses of the proposal to see how it affects the various—relative tax burden of the various groups or various people, income groups?

Senator KASTEN. Mr. Duncan, we have in terms of trying to look at three or four parts of that question.

Part No. 1 is the relative impact on corporations as opposed to individuals, and as you know, in the Treasury proposal, you see an increase in the corporate revenue side and a relative reduction in the individual's side, an increase of about 37 percent in corporate taxes overall and a reduction of about 7 percent in individual taxes overall.

Kemp-Kasten is roughly equal between corporate and between individuals. Within overall also, the plan is revenue neutral. In other words, tax reform ought not to be a guise for tax increases, and this bill, our proposal, will not either raise or reduce revenues received.

Last, with individual income groups we have to the best of our ability analyzed this and we are trying to work with income groups in rough parity to where they would be, with one exception, one important exception, the people at the very bottom.

The people at the very bottom, the working poor, would receive significant tax reduction, in our effort at trying to reduce that penalty of going to work in the initial entry job. Roughly speaking a family of four would begin paying taxes at $14,125 under the Kemp-Kasten proposal. That is significantly higher than is the present law.

We are making every effort to stay revenue neutral within the various categories with the exception of the very lowest.

Mr. DUNCAN. Do you think that we should award the risk takers in this country? Do you think we should reward the risk takers in this country or not?

Senator KASTEN. I believe we should and we must reward the risk takers in this country, and it is one of the reasons we have a preferential treatment for capital gains. I hope that whatever we do in tax reform that we continue to have a preferential treatment of capital gains; not from the securities industry point of view, although that is an important point of view, but from the point of view as the venture capitalists.

There has got to be a pool of venture capital to reward the risk takers in this country and that pool of venture capital depends in large part on capital gains.

So, whatever we do, we don't want to take away that little extra reward that people receive by having a preferential treatment for capital gains. We don't want to take away that little extra reward, because we don't want to slow down the ability of these people to take that little extra risk.

That risk is what America is all about and it ought to be rewarded.

Mr. DUNCAN. Again, thank you. Thank you.

Mr. FLIPPO. Thank you very much. We thank you for your testimony.

I believe this concludes our witnesses and the committee will stand adjourned to the call of the Chair.

[Whereupon, at 2:55 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF HON. CHARLES E. BENNETT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

There is a clear and pressing need for us to correct the problems of the present tax system, which allows many wealthy people and successful corporations to make a sizeable income and yet not pay any taxes at all on that income. This drives up the deficit and forces the average taxpayer to shoulder a heavier burden.

The tax loopholes that permit this situation cost the Americans a tremendous amount of money. During 1984 alone, it has been estimated that the U.S Treasury will lose $24 billion because of tax shelters. The December 1984 issue of Fortune magazine listed 15 major corporations that have paid no taxes since the 1981 tax bill was passed, even though they had total profits of more than $14 billion. In fact, many of these companies received tax refunds. In addition, the Internal Revenue Service has compiled statistics showing that over 20,000 people with adjusted gross incomes over $50,000 paid no income tax in 1982.

It is utterly wrong and beyond ethical comprehension for some people and corporations to avoid paying taxes when they have substantial incomes, while other honest and hard-working individuals and businesses struggle to pay more than their share of taxes.

I have introduced a bill, H.R. 18, that would impose a Minimum Tax of 10 percent on net economic income over set minimums for individuals and corporations. This legislation would ensure that wealthy individuals and corporations do not crawl inside their loopholes or under tax shelters to escape the responsibility they owe to the American people. It is not a surtax, or a tax increase. Anyone already paying more than 10 percent of his income in taxes would not be affected. It only applies to individuals and corporations who pay less than 10 percent, and it applies only to amounts above the minimums set in statute.

My bill defines "net economic income" as the total amount of income received during the taxable year, which can be reduced only by necessary expenses incurred in producing such income and by a reasonable allowance for the decrease in property used in connection with the income. It covers all income that would otherwise be tax exempt, like interest on state and local bonds, Accelerated Cost Recovery System depreciation deductions, and deductions for oil depletion and intangible drilling costs; but only if the income above the exemption amount makes use of such deductions.

The exemption covers $40,000 for joint returns, $30,000 for unmarried individuals, and $10,000 for corporations. Only income over these amounts would be covered by the 10 percent tax.

Without unfairly raising anyones' taxes, H.R. 18 would bring in substantial amounts of revenue. Over the next five years, from FY 86 through FY90, I am advised this bill could bring in over $125 billion. This would be an important contribution to reducing the federal deficit and maintaining a healthy national economy.

There has been a lot of talk about a "flat tax," and how it would simplify the tax code and close loopholes. The three proposals, The Treasury plan, the Bradley-Gephardt Tax, and the Kemp-Kasten Tax, would lower some tax rates and cut the number of tax brackets. However, these proposals would not prevent corporations and individuals escaping all taxation.

A lot can be said for the aspect of the flat tax in removing overgenerous loopholes, but little virtue lies in their removing the progressive nature of our tax system. The system of progressive tax brackets is not all that complicated—it only takes a minute to run your finger down the column to figure out your income tax, once the amount has been determined upon which the tax is to be paid. There is no real reason to reduce the number of tax brackets, and it could weaken the progressiveness of the tax code.

Moreover, it is not at all likely that flat tax proposals will become law. The intended beneficiaries of the subsidy loopholes, such as charities and cities, are not likely to take this lying down. Once that first loophole slips in, others will follow until the flat tax proposals fall apart. H.R. 18 does not eliminate deductions, but only requires that the person or company pay at least 10 percent tax on his income above the generous level set by the statute. H.R. 18 should not encounter such stiff political opposition as the flat tax proposals. I urge that prompt consideration be given to H.R. 18, whether or not the flat tax proposals are accepted. It is something that can pass! It will go a long way toward fairness in our tax system.

STATEMENT OF HON. DENNIS DECONCINI, A U.S. SENATOR FROM THE STATE OF ARIZONA

I thank the Committee for the opportunity to discuss my proposal to bring about major tax reform through the creation of a tax system that is broadly based and employs a single uniform rate of taxation. I first proposed this idea in 1981. It was the first proposal of its kind in the Senate and I like to think was the seminal idea for many of the other proposals for tax reform that have followed. I applaud the efforts of my colleagues who have proposed their own tax reform bills—I think they are all better than the present IRS Code—but I continue to believe that the proposal embodied in S. 321 best meets the needs of the Nation. It is the simplest, fairest, and most efficient means of raising revenue.

The time of the Committee is short and you have heard descriptions of my bill and others ad infinitum if not ad nauseum. Last year the Committee heard from Drs. Hall and Rabushka of the Hoover Insititute for several hours. They are the economists who developed the ideas that led to my bill. I gladly adopt all of their testimony as the most eloquent statements and explanation of the bill. I shall take just a moment to summarize the highlights of the proposal.

In short, the proposal calls for a 19% rate of taxation for all personal income above an excluded level, and a 19% tax on all business income. All credits, deducations, and depreciation are eliminated. First year expensing is substituted for depreciation. Income is taxed once, and as close to its source as possible. Indexing is built into the bill.

The Committee in its letter to me of March 7, asked for comment in four areas: economic impact, relative burdens, revenue consequences, and simplification features.

Let me begin with the latter. Without a doubt my proposal is the simplest, most easily understood of the suggested reforms. You have attached to copies of THE FLAT TAX, the tax forms that would be needed to comply with my flat tax system. They are the size of a postcard, straight forward, and could be filled out in minutes by any taxpayer without the need to solicit professional assistance. The public wants tax reform, but it is my experience that the single largest ingredient in that wish is for tax simplicity. In the simplicity department, the Hall-Rabushka-DeConcini proposal has to be conceded as the hands down winner.

In the relative burden area, again I feel my proposal meets the test of fairness. Wage earners at every income level by category will pay less under the proposed flat rate system. I refer you to the chart on page 76 of the book for a comparative analysis of tax burdens under present law and under my proposal. The flat tax shifts the tax burden away from wage earners and towards non-wage business income earners. I would summarize the distributional fairness of the flat tax as follows:

1. The current personal and corporate taxes tax wages heavily and business income lightly. The flat tax would reverse this inequity and benefit the great majority of Americans, whose income comes almost entirely in the form of wages.

2. In comparison to the current personal income tax on wages, the flat tax would impose a lower burden on both low earners and high earners. Those in the middle, around $25,000 in annual wages and salary, would pay about the same in taxes. In the years following tax reform, this group, along with others in the economy, would benefit from increased growth, so it too would come out ahead from the move to the flat tax by earning higher after-tax incomes.

If we are right that improved incentives will actually raise real income by 9 percent after seven years, then it won't take too long for the taxpayers who lose at the outset to come out ahead. The worst immediate impact of the flat tax is to reduce after-tax incomes of people who have been aggressive and successful in keeping business income out of the hands of the IRS or who have created negative business income to offset their salaries. The tax rates on their business incomes will rise from negative or zero to 19 percent. But these people are particularly likely to be able to take advantage of the growth of the economy stimulated by improved taxation.

The economic impact of a flat tax system will be all positive. It seems almost a truism that with a low tax rate of 19% that investment will be channelled into productive enterprise, incentives to work and save will be greatly enhanced, and the underground economy will surface as the reasons for its existence—high tax rates—are eliminated. I predict an investment boom and high rates of growth would accompany passage of a flat tax system.

Finally, on the issue of revenue consequences, my bill is revenue neutral in its first year. Ensuing years will see increasing revenues and a corresponding decrease in deficits. Hall and Rabushka predict that a balanced budget would occur some time near the end of the next decade.

I believe the Hall-Rabushka-DeConcini proposal far and away is the best pending proposal when it comes to tax simplification; it meets the test of fairness—no wage earner by category will pay higher taxes under the proposal; it will stimulate the economy and make for much more productive channelling of investments; and it will meet the revenue needs of the country while gradually working towards a balanced budget.

TULSA, OK, *April 25, 1985.*

Hon. DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee, House of Representatives, Rayburn House Office Building, Washington DC.

DEAR MR. CHAIRMAN: I am enclosing a statement entitled "Tax Simplification" with a request that it be made a part of committee records of hearings on this subject.

I hope that when the hearings are in full course, the advantages of taxing retail sales which are indicated in the enclosure, will be given at least equal consideration as are the proposals for tinkering with the present income tax system.

I also hope that information on this subject may be disseminated to all Committee and House members.

Sincerely,

EDGAR PAUL HAWK.

TAX SIMPLIFICATION

A. PROPOSED TAX SIMPLIFICATION

1. *Abolish taxes on income: free everybody from all income tax reporting.*

There is widespread agreement on the need for simplifying the present system of collecting taxes, which involves many millions of people, of tax returns, and of withholding and compliance reports. Thousands of pages of regulations, interpretations, and instructions define amounts of taxes due under different circumstances.

2. *Substitute new federal tax on retail sales of goods and services.*

Nobody would be involved in collecting and reporting taxes except businesses selling at retail (whose additional costs, if any, could be compensated). Tax calculations would involve only two simply steps by the retailer: (1) Apply a standard sales tax percentage rate to the gross amount of each customer purchase ticket; and (2) Add up the sales tax totals on all such purchase tickets. Auditing and enforcement would be limited to comparing tickets, total sales and tax totals, thus requiring little interpretation of regulations.

State sales taxes could also be calculated separately as a third step. State and Federal tax agencies could share compliance and enforcement activities.

3. *Separate preferential treatment from tax collecting.*

Desirable discriminatory treatment will be handled separately through regular legislative process: authorization, appropriation, and expenditures. This includes subsidies, credits, incentives, income supplementing, and other low income assistance.

B. UNIQUE ADVANTAGES OF THE FEDERAL RETAIL SALES TAX

1. *Make 100 million Americans happy by relieving them of all tax reporting requirements.*

Under the new system, taxes will be collected from the retail purchaser—without reporting by him—as a part of each purchase. Employers would no longer be required to withold income taxes from salaries and wages they pay, thereby increasing take-home pay.

2. *Free Congress to act on this and future tax measures.*

Relieve Congress from all pressures by lobbyists and special interest groups seeking preferential income tax treatment. There would be no preferences to seek under the retail single-tax system.

3. *Eliminate all loopholes simultaneously and impartially.*

This includes all deductions, exemptions, exclusions and other provisions for deferring, curtailing, or avoiding payment of taxes. (For objectors: this is giving the "whole loaf"—not taking the partial loaf).

4. *Help correct unfavorable U.S. balance of international trade.*

Abolishing income taxes would enable manufacturers and exporters to lower their export prices by the amount of these taxes (plus markups on taxes). Exports should be exempt from a domestic retail sales tax. This would make U.S. export prices more competitive overseas.

On the other hand, foreign taxes paid on overseas production of imports into the United States remain unchanged. Imposition of the new U.S. retail sales tax on imports should result in higher prices and lesser import competition in the United States market.

5. *Remove tax consequences as an important factor in business decisions.*

The private enterprise system can operate freely for purely business reasons without tax consequences. Business cannot, of course, permit retail prices plus sales tax to become uncompetitive. With this greater freedom, private enterprise should produce more employment, consumer buying, and taxes.

6. *Gain universal respect for the United States tax system.*

Every citizen will know that a single federal tax rate applies equally to every retail dollar spent anywhere in the United States by anybody at any time. Most taxpayers are already convinced it is their patriotic duty to pay their *fair share* of taxes, but they resent the present system as unfair, complex, and full of loopholes.

7. *Establish a simplified tax system easy to adjust.*

The single tax rate can be "fine-tuned" simply and quickly at any time budget requirement or the economy dictate. The Congress can accomplish this without pressure of tax preference seekers.

8. *Save the public many millions—if not billions—of dollars and mandays in preparing tax returns.*

These amounts are now spent each year by individuals, businesses, professionals, and the government.

9. *Federal revenues should start an upward trend without raising tax rates.*

An increase in exports and a decrease in imports would result in increased U.S. employment, consumer expenditures, and retail sales tax revenues. (no tax losses)

A new U.S. sales tax on imports would also add a net increase to tax revenues.

Stimulating savings and investment by taxing retail sales rather than income should contribute to modernization and steady growth in the economy and revenues.

One-time gain in tax revenues would also be added by those paying their last (1985) income taxes after January 1, 1986 (assuming the new retail sales tax became effective on that date.

10. *Create a new and significant influence to act as a counter against inflationary tendencies.*

11. *Open the door for future additional decreases in the federal deficit and debt by having broadened the tax base to its maximum.*

12. *Achieve increased revenues from the new retail sales tax without raising taxes.*

Accomplish this by: (a) collecting sales taxes from some 50 million people (of the total population) not now paying income taxes; and (b) collecting sales taxes on expenditures of income now excluded from "adjusted taxable income" on some 100 million income tax returns.

C. BUSINESS PAYS NO TAXES

It is not certain why Congress, although aware of it, has not taken an official position on the question "Does business pay taxes?". The answer is "No, the consumer does."

Every business man producing and/or selling a product or a service sets a price that will return his direct and overhead costs-plus-taxes and profit on it. If the customer is another business, it adds this cost to its other direct and overhead costs of the product it is making, and adds on its own taxes-plus-profit. Ultimately, the consumer pays all of the accumulated costs-plus-taxes-plus-profits of all firms involved.

The government now collects taxes on net income, if any, from some 17 million private businesses. However, since each business is only the conduit for taxes passing through from its customers, the question arises "Aside from inspiring political rhetoric, why should business have to comply with complex income tax regulations at all?

The only permanent result of increasing taxes on business and "big corporations" is to raise prices to consumers—and to conceal it from them!

D. FUNDAMENTALS WARRANT CHANGING TAX BASE FROM INCOME TO SALES

1. *Summary: Tax Background.*

The U.S. Economy consists of four types of institutions which citizens have created to provide for their own needs, desires, and aspirations. These four are: Private Business Enterprises; Religious, Charitable, and other Non-Profit Organizations; State Governments; and the Federal Government. Each type of institution controls facilities in all areas of the nation which are necessary to provide different types of things desired, paid for, and owned—by private citizens or collectively—by the people.

These great private and public institutions have flourished in the unique American climate of democracy, individual initiative, and competition. With private citizens as entrepreneurs, managers, professionals, and employees, of the many facilities, they have developed the world's greatest output of ideas, goods and services, and its highest standard of living. All institutions have growing assets, credit—and debt. They have growing income from purchases, donations, and taxes—all originating with the people. These financial resources, in turn, provide the source of all the nation's salaries, wages, dividends, and interest—which keep the production-consumption cycle accelerating. Total consumer expenditures by all of the people receiving these salaries, wages, dividends, and interest (plus credit) provide the funds for all three kinds of buying and selling that occur within the private enterprise system: (1) purchases paid with taxes and donations; (2) purchases between private businesses within the production and distribution process; (3) purchases of goods and services directly by consumers. The third group, which incorporates funds for the other two, supports the U.S. economy.

Collecting taxes on the third group as it funnels through retail sales outlets would collect more revenues and trouble far fewer people than taxing income, as is presently done.

2. *Every business must buy from many other firms.*

Not one of the millions of private enterprises is self-sufficient. They have to work together to produce millions and millions of different products and services.

To keep its own operation going, each enterprise must buy some of its needs from other firms—possibly as few as 25 and as many as hundreds, Production processes might require buying anything from raw materials and machinery, through semimanufactures and components, to the finished product, Most buyers want two or more suppliers of everything in order to get competitive prices and reliable sources.

Many business firms produce components, products or services useful only in the manufacturing or sales operations of other businesses. They never sell direct to retailers or consumers. Many sell to both. All firms buy services of various kinds—from a dozen or more suppliers each year. Services (such as utilities) are also sold directly to the consumer.

Every supplier allocates its costs and profits in setting prices on each item. This includes allocation of all business and employee income taxes.

The intricate relationships between many different private enterprises can be illustrated by the hundreds of different firms involved in some aspect of converting raw materials into an automobile or an airliner coming off the assembly line. Paying all costs of all these business firms and activities are the people who buy tickets from the airline which invested in the airplane, and the consumer who bought the automobile.

Why not tax sale of ticket and car rather than hundreds of differently interpreted and "calculated income" tax returns of all the firms involved?

3. *Every business charges all taxes to its customers.*

So customers can order any quantity, manufacturers set unit prices for each product ("X"). This requires the exact cost of everything going into one unit, including:

(a) Cost of everything purchased to produce one unit of product "X" (cost includes taxes of the business and its employees).

(b) Cost of salaries, wages, and employee income taxes and withholdings to produce one unit of product "X".

(c) Cost of company administrative and overhead expenses chargeable to one unit of product "X".

(d) Company percentage markup to cover profits and taxes. Percentage applied to total of (a) + (b) + (c).

Every business firm thus covers two types of costs in its selling price. First, it has paid costs of other firms which supplied items needed to produce product "X". Second, it added its own costs specifically related to product "X"—labor, overhead, taxes for itself and its employees, and profit.

If product "X" is a pair of blue jeans, and the retailer puts a $30 price tag on it, private enterprise has collaborated to set that price.

That $30 price now includes the exact fractional charges made by all separate businesses or operations necessary to produce a pair of blue jeans. These included: Steel and other raw materials, machinery, agricultural machinery, textile machinery, seeds, fertilizer, banking, cotton farm, cotton gin, spinning mill, weaving mill, chemicals and dyes, industrial sewing machines, clothing manufacture, utilities, automotive, air and railway equipment, truck, rail, and airlines, warehousing, advertising, telephone, office supplies, store equipment, retailing, etc.

When a consumer pays $30, he paid back all of those charges that went into this particular pair of blue jeans. When all consumers buy from all the retailers all blue jeans of that particular manufacturer, consumers collectively pay the total costs—including all business and employee income taxes—of producing and selling all of that brand of product. When other consumers buy all of the blue jeans sold by all other manufacturers, the same becomes true of the nation's total production of blue jeans in the United States.

All taxes connected with this product have been paid—by the consumer.

Retail prices of products "X", "Y", "Z"—of all products and services sold on local, national, and world markets—are set in the same way. Prices in each sale to a consumer cover charges by all separate business enterprises for whatever they supplied to make that specific sale possible. Total consumer expenditures at retail covered all taxes.

4. *Consumers, in effect, are now paying Retail Sales Tax.*

Some 250 million American consumers spend about $3 trillion to buy all of the many millions of products and services sold to the public in one year. Total consumer expenditures cover all producing and selling costs, including all profits and all taxes of some 17 million private business enterprises in the United States.

Consumers, in effect, are now paying the "retail sales tax". Taxes are included in the prices of varieties of products almost infinite; purchasing power rarely is. Both are results of competition.

Because taxes are a percentage of net profit, businesses have to set prices enough above costs to be assured there is profit after taxes. For employees, prices cover both wages and amounts withheld for taxes and benefits. The consumer pays these combined charges. Later adjustments in the tax share of the total are immaterial. The consumer has paid both shares in his/her purchase prices.

Right now, all consumers are paying in their purchase prices at retail the amount of taxes set by the private enterprise system. Each taxpayer, regardless of income status, is paying on the same price and tax basis as every other taxpayer. If the sales tax system were now in effect, taxes collected at this point would go directly to the Treasury.

Currently the retail price to the consumer includes all income taxes. Under the sales tax system, the Government's percentage would be added after the consumer has completed his/her purchases (at lower prices because no taxes would be in them). In both cases, after paying about the same amount, the consumer has paid all taxes. However, under the current system, the Government does not get all of the revenues.

The income tax is applied at the other end of the "chicken or the egg?" business cycle of production-distribution-sale-consumption. Taxing income involves 50 years of interpretation as to what income is and what to do with it. A sales tax should start less encumbered with exclusions.

Right not, all residents of the United States are, in effect, paying taxes when they buy products or services. However, possibly as many as one-fifth of the total population do not pay income taxes. Because of this, the tax dollars they are not paying do not reach the Treasury. With a sales tax, there should be no way of escaping.

People paying no income taxes include: the wealthy ("tax free" and "sheltered" income) and the low-income (tax exempt); organized crime and criminal elements (no or inaccurate tax returns); and people filing no tax returns: "the under-ground economy", illegal aliens, foreign tourists and visitors, foreign and domestic students, and others unknown.

Another loss of Government revenues occurs because of the escape of income from taxation under the current system. Complex income tax regulations permit different kinds and amounts of income actually received to be excluded from "gross income" in order to arrive at "adjusted taxable income". This "excluded money" provides funds for more consumer buying—and loss of revenues that would not escape a sales tax.

Without data, it is impossible even to guess how much "tax money" now acutally being spent in consumer purchasing escapes the Government. However, if the equivalent of one fifth of the total population not paying income taxes does anything approaching average spending, this might amount to $500 billion of which a retail sales tax of 20% would yield $100 billion. If 75 million business and individual income tax returns permitted exclusion of $5000 income each, that would add another $375 billion spent and $75 billion taxes.

Whatever actual amounts are realistic, they are being spent and taxes are escaping now. And a sales tax would capture these unnecessary losses, without really giving anybody reason to be perturbed.

5. *Federal and State Governments as consumers.*

Spending taxpayer's money, and representing citizens collectively, both the Federal and State Governments act as "consumers", buying both ordinary and specialized products and services. "Specialized" indicates items produced to Government specifications and not for private use. For example, the Federal Government is responsible for national security. It buys military equipment. The State Governments are responsibility for roads and sanitation which private enterprise finds unprofitable.

To the extent that private business enterprises now dealing with these Governments are taxed on their business income, they do as all private enterprises—they pass taxes along in their prices for customers to pay. The "customer" pays out of taxes.

Government contracts could be exempted from a sales tax.

6. *Conclusion: Sales Tax assures Government neutrality toward private enterprise.*

Since production precedes sales, income taxes introduce tax consequences into business decisions.

Private enterprises working together now set prices on a competitive basis but taxes are now a part of each step. A sales tax would remove tax consequences as a factor in business decisions. Final retail prices, competitive relations, and growth would be the concern of unfettered private enterprise. A flat sales tax rate on all prices will maintain the Government's strict neutrality, leaving all competitive prices and other relationships unaffected.

This would change the fact that now, if a business mistake is made, it will be only half as bad because the Government will pay nearly half of the cost of that mistake. A sales tax would cause no such assumption.

The amount of working capital needed to carry inventories would be smaller by omitting all taxes until the consumer completes the purchase. There would be no capital tied up in taxes in the pipeline between raw material supplier and the ultimate consumer.

Widespread TV and other advertisements of books and services on "how to get wealthy by manipulating taxes" would have little room for manipulating sales taxes.

The private enterprise system is free to fail as well as succeed. Products fail—either to find a market or sell enough at profitable prices. Similarly, each year private firms fail for a number of reasons. Under the income tax system the Government bears the brunt of such failures with lost tax revenues. Under a sales tax system, the Government would obtain its percentage of every dollar spent—regardless of profitability. The Government would not be involved in absorbing losses by businesses.

Reduction of the Government's role in taxation to nil or neutral would not imply that "private enterprise" is "free enterprise". All of the nontax governmental safeguards remain in effect. These include: anti-trust, labor, safety and health, product standards, food and drug, interstate commerce, environmental protection, transportation, banking, mining, liquor, tobacco, firearms, etc.

E. EQUITY AND FAIRNESS DEMAND CHANGING TAX BASE FROM INCOME TO SALES

1. *Summary.*

In comparing tax systems, the most important single factor is the willingness of the people to pay their fair share. On this basis alone, the present system is a failure. Proposals merely to alter the present income tax system would not eradicate all of its faults.

Taxpayers commiserating with each other find common beliefs. Everybody hates tax forms. They hate losing their own time as well as having to hire costly professsionals to help prepare tax returns. They hate hearing of others who don't pay their fair share! For many, this is more important than the money!

Taxpayer attitudes have changed. No longer is it unpatriotic or dishonest to avoid taxes. Everybody else does. Complicated instructions tell how someone can avoid or reduce taxes.

One universal rule has evolved: Every taxpayer owes it to himself to do everything legal—or undetectable—to reduce or omit taxes. Most have heard that only 2-3 percent of tax returns are audited. If any item is questionable, decide it in favor of the taxpayer. (If he gets caught later, he can always pay).

Who knows how much the government loses in tax revenues because the public perceives that the income tax system is unfair? Or how much because government regulations provide for discrimination and preferential treatment?

2. *Intended discrimination is built into the graduated tax rate schedule.*

The present income tax system that a person earning higher income can afford to pay a higher tax rate. About 14 higher tax rates apply to as many higher income brackets. Some proposals would cut the number of tax brackets—but not eliminate all.

Some apparently consider discrimination desirable when people in each higher tax bracket get equal rate increases. However, equality is not necessarily equitable: Assume "equal taxpayers file joint returns showing "Adjusted Taxable Income" of $50,000 each. The first couple includes one worker. In the second, man and wife work. In the third, a man works longer hours at two jobs. The fourth return is from a man who will soon die, leaving his wife huge debts and a mortgage house. The fifth couple have six children, and were allowed $6,000 exemptions for their high-school and college expenses. One final comparison: a couple shows "taxable income" of $25,000 (taxable at a lower rate), all from a taxable pension, but owns $1,000,000 in tax-free bonds.

With so many unknownable differences, no way can an income tax system discriminate between taxpayers without causing more injustice than it cures. How could the government know who is more "deserving"?

Another inequity is apparent. This system penalizes success—and the greater the success the greater the penalty. This directly contradicts the faith and beliefs of a majority of Americans. America is great because of its private enterprise system. Private enterprise is great because of individual initiative, which in turn requires pride, effort, growth, and success by individuals. Present tax policy is inconsistent with pride in these results.

3. *Retails sales tax captures revenues that escape income tax system.*

To the extent that they buy U.S. goods and services, that is the exact extent which everybody residing on U.S. soil pay retail sales taxes. Taxpayers could not escape taxes unless retail businesses escape or conive—a serious offense.

Most people feel it is an injustice for others to escape all taxes. Everybody owes some debt of gratitude for living here: for our freedom, security, and protection. And for our standard of living which—even at its worst—far exceeds that of 85% or the world. Everybody should pay taxes to learn and be reminded that the government has no money and cannot create it. It comes only from taxing people—not even from taxing corporations. Some taxpayers may get their taxes back—and more—but they know from where.

The government does not now collect income taxes from possibly 50 million or more people out of the total population. The wealthiest and the poorest are exempted by income tax regulations. Additional millions do not file income tax returns. Presumably, they are buying U.S. products and services and paying the same prices as everybody else. These prices now include taxes as a cost of doing bussiness. The government gets no revenues because no one pays income taxes. Chaing the tax base to retail sales would, in effect, add 50 million new taxpayers—who are already paying the same amounts anyway.

4. *Government regulations of business cause lost revenues.*

General Electric recently had publicity accusing it of making billions of dollars in profits but paying no taxes for three years—and in fact receiving $280 million from the government in one of those years. Some 129 other firms were said to have similar histories.

Many firms, certainly GE included, have to maintain permanent staffs of professionals, including lawyers, accountants, and tax specialists, to comply with the many tax regulations. GF must believe it is acting legally, and, if the government paid, it must agree.

These stories reenforce two important reasons for wanting a change in the tax system as it affects business.

Ever since the rule of "tax tax—spend spend—elect elect" was enunciated, it has been standard practice to use business, and especially big business, as a whipping boy for taxes. Even in the last election, the losing candidate almost daily bragged he would "soak the big corporations". This is not possible. Business pays no taxes from its own capital investments—and probably could not be forced to do so constitutionally (confiscation). Tax action to "soak business" would result only in increased prices to consumers.

In addition, it has been demonstrated that consumers pay enough in their purchase prices to cover all taxes and profits, as well as all other costs, expected by the entire private enterprise system. That the results for three years for General Electric was a net return of revenue from the government illustrates that something must be wrong with the government's complex instructions telling business how they can operate under tax regulations.

It is not known whether the decision to have part of federal revenues collected by and flowing through business, closely regulated, was happenstance or not. Perhaps it was to conceal from consumers that, collectively, they were paying not only the amount of income taxes shown on their individual tax returns, but also unknown to them, an additional amount of taxes concealed in the prices they pay.

Considering that private enterprise is the reason for America's greatness, business respect is due.

5. *"Shell game" and discrimination for personal income taxpayers.*

On similar amounts of income, U.S. citizens pay differing amounts of income taxes, depending on complex factors and circumstances. These include: amount and kind of income, age, blindness, marital and dependency status, occupation, retirement, location, homeownership, health, insurance, business, investments, reading matter, record-keeping, etc. "Short Forms" are available for eligible taxpayers. Itemized "Long Forms" are mandatory for others.

"Taxes due" conclusions differ depending on complexity, whether help is hired, and on the reading, rcord-keeping, and calculating skills of each individual. The income tax system tries to allow for human differences. Accomplishing this with 100 million mailed tax returns is not easy. Discriminatory treatment is bound to occur.

However, every taxpayer suffers injustice because he is paying considerably more taxes than he has been given any reason to believe. All businesses are reimbursed by their customers for their taxes, and the consumer is the ultimate customer. Consumers collectively pay all business taxes in addition to their own income tax returns.

Since consumers now provide all federal revenues, in the prices they pay at retail, sales taxes would be primarily a difference in timing rather than of amounts collected. Individuals would no longer have to calculate or file personal income income tax returns. They would be paying taxes with each purchase. They would be sharing taxes on a basis of absolute equality which is at least as fair as the present system of paying both overt and concealed taxes.

Any discrimination of the new system would be "fact-of-life" differences established by private enterprises in free competition. A pound of caviar might cost as much as thirty pounds of butter. A Cadillac might be worth 300 bicycles. But the taxes would also be thirty and three hundred times as much.

6. *Sales tax equalizes tax burden of middle income earner.*

The people in the middle income classes suffer most from the failure of other people to pay their fair share of the present income tax burden. Many wealthy or with higher incomes have their income in the "tax-free" area. Lower incomes are tax-exempt. Many taxpayers do not report all income, especially untraceable cash transactions. Some businesses have unreported cash receipts. Some people pad their expense accounts. Some hire "workers" who don't work. Some charge personal items to business.

Some of the middle income class feel "the inequity of being unable to cheat". Their only receipts—salaries, wages, dividends, and interest—are reported to the government. This group, has been expanded greatly by the addition of working women. Collectively, this group has to make up for the lack of "fair share" paid by other people.

With all people already buying and paying equal prices to the extent of their purchasing power, a retail sales tax would collect federal revenues, without changing existing living patterns, in a way that the income tax system cannot do.

7. *No tax work!*

Probably the most widespread feeling of discrimination and being "put upon" comes from the agonizing that many people have to do over the preparation of their tax returns. Many have to pay for help. Many would undoubtably pay as much—or more—not to have to prepare tax returns at all!

F. ANNEX: SOME SUGGESTED GUIDELINES

1. *Consensus.*

What Americans, noted for patriotism, common sense, and being fed up with the income tax would not applaud change to a sales tax which asks nothing but spending as usual—and costs exactly the same number of tax pennies per dollar?

2. *Philosophy.*

The sales tax is repayment exactly in proportion to the amount of goods and services each citizen has received for use, consumption, or enjoyment.

Income, savings, investment, and wealth are goals of each citizen, necessary for future growth of technology, facilities, living standards, and quality of life. Wealth is always working somewhere as investment to create more and better jobs. Our nation has proved that private enterprise is more productive than communism or socialism.

Income, capital, and wealth are not taxed. Education is a form of investment.

3. *Obligations.*

Legislation will require businesses and professions selling goods and services to the public to collect, record, and pay the sales tax to the Government. Individuals making purchases are obliged to pay the sales tax. They have no other obligations.

Sales taxes are imposed only once—at the point of final sale.

Business sales to other business enterprises for further processing, manufacturing, assembly, and re-sale before or after manufacture are not subject to the retail sales tax.

The crux is whether money will change hands upon any further transfer of the goods or services. If not, it is taxable.

The sales tax does not apply to transfers of money, which will be taxed upon being spent.

4. *Registration of retail sales tax collectors.*

The government will take necessary steps to have contact with and register each business and professional entity which will be obliged to collect and submit retail sales taxes under regulations supplied them.

A question to be answered is whether any percentage allowance is needed for retail outlets to cover extra costs involved in collecting retail sales taxes for the government.

Early discussions with business and association leaders should enlist cooperation and plan registration of individual retail outlets.

5. *Percentage rate of sales tax.*

Further study will be required before setting the "official" percentage rate that will be applied to each retail sale. The public might always have two rates in mind: (1) the "norm"—or that percentage rate needed to balance the budget; and (2) The "official" percentage rate which will be used because of the economic and political outlook.

To illustrate this suggestion, the table assumes a $4 trillion Gross National Product. The "current" percentages are from Congressman James Wright's recent statement that the Government "needs" 25% of the G.N.P., but now "takes" only 19%. Note that a 1% change in rate would equal $30 billion of consumer expenditures.

	Assumed "norm" to reach balanced budget					
	Amount (billions)	Percent of GNP	Percent of consumer	Amount (billions)	Percent of GNP	Percent of consumer
Item:						
Gross national product	$4,000	100	133.33	$4,000	100	123.45
Government	1,000	25	33.33	760	19	23.45
Consumer expenditures	3,000	75	100	3,240	81	100

6. *Data needed: Revenues added by change to sales tax.*

Taxing the same amount from the economy, whether by income or sales taxes, would probably impact taxpayers more than the overall economy.

The following are major factors affecting revenues and percentage rate:

Present income tax: (a) Business and individuals pay direct taxes under separate rules.

(b) Both taxes are included in selling prices of goods and services. Business gets its taxes back.

(c) All individuals pay equally the taxes contained in the products they buy.

New Sales Tax: (a) Business omits its taxes from prices. This should permit lower retail prices by the aggregate total of all business taxes plus normal business markups on tax amounts.

(b) Most employees get significant "take-home" pay increases to the extent income taxes were formerly withheld from their wages. This would not affect prices (which have always contained both wages and tax withholding). It would increase purchasing power.

(c) All income taxes of all individuals, now cancelled, increase the tax base to which the sales tax percentage will be applied.

(d) Millions of people paying no income tax but buying products and services will now have the sales tax applied to their purchases, broadening the tax base. (These millions described in section D-4.)

(e) All business and individual income tax returns exclude authorized amounts of money from "gross receipts" to arrive at "adjusted taxable income". Monies previously excluded are spent and will broaden the tax base further for the new sales tax.

The net results of these important factors are clear even before developing statistics:

(1) If the same total of tax revenues were obtained from the same people formerly paying all of the income taxes, substantial increase in total tax revenues would result from the broader sales tax base, or;

(2) A lower sales tax percentage applied to the broader sales tax base would result in the same amount of revenues in the same period of time.

7. *Excise taxes.*

Were different tax rates desired for "unhealthy", "luxury", or other products, this should be accomplished by an excise tax on the manufacturers. The retail sales tax should be limited to one percentage.

8. *Identifying point of "retail sale"—and tax.*

Products.—Many retailers, retail outlets, and retail products identify themselves. Some require "tracking" to find where the consumer pays. For example, there are airliners, business airplanes, and small airplanes. Consumers buy airline tickets to pay for the first; businesses sell products or services to pay for the second; and the third may be bought by a consumer who pays sales taxes. If the smaller airplane is bought by a pilot training service, the training lessons pay for the plane. Whatever pays for each is taxable.

Services.—The same is true for businesses which sell services. For example, the utility which sells electricity to the automobile assembly plant for power and lighting collects no retail sales tax on that particular sale. The assembly plant pays the utility bill and includes that cost in the price of the automobile it sells. But the electric bills going to the officers and employees of that assembly plant are retail sales to consumers and are taxable. Some businesses selling services, such as utilities and transportation, sell to everybody—other businesses (not taxable) and direct to consumers (taxable).

Product or Service?—Factory buildings and commercial office buildings represent investments and sales taxes which are not paid on the building materials going into them.

Factory building costs are included in the prices of products made in that factory. If such products are sold to consumers, sales taxes are paid when such sales are made. If sold to another business, such as a retailer, sales tax is not paid until a consumer buys.

The commercial office building rents space, but consumers rarely rent it. Sales taxes are collected when the businesses renting the office space sell their products or services to consumers.

9. *Used or second-hand products.*

It is assumed that businesses dealing in such goods would be subject to the same rules as all other enterprises. For individuals, it may be desirable to get some limit such as $1,000 in sales per year, below which amount no tax is required.

10. *Cash or installment sales.*

Whatever the terms established by buyer and seller, sales tax would be collected upon each amount as paid in each installment. Fees or interest or other charges for paying by installments are a part of the sales price. Each installment shall have—and be presumed to have—its percentage of sales tax included.

11. *Rule on exceptions.*

Since making any exception is a precedent, none is contemplated.

12. *Policy on taxes, prices, and hardships.*

Many private enterprises developed the competitive relationships between the prices of all products and services, as well as between all salaries and wages. The government's standard sales tax does not change these relationships. Under the income tax system each business had to add taxes at each step of the manufacturing and distributing process. About the same taxes are now added after the consumer buys instead of before.

Price levels should generally be lower by the amount of income taxes dropped before the retail sales tax is calculated. Without income tax withhoding on their wages, most employees should have higher purchasing power. Most should be relative better off than under the old income tax system.

Private enterprise sets prices to cover costs, meet competition, and stay in business. The Government attempts to set taxes with the same things in mind. However, if the Congress decides some citizens merit help in paying these realistic prices, such help costs far less and helps those who need it far more if accomplished through the direct appropriation side of government. Trying to achieve this on the tax side costs more because it has to help those not needing help.

13. *Policy on Single Tax Rate.*

A single tax rate for all products and services, payable by all individuals, is simple, non-discriminatory, and sets no bad precedents. Industries or products might be picked out for special tax rates. Special rates for selected consumers would not be feasible to administer. Common sense says ordinary sales clerks cannot be expected, especially during business rushes, to make difficult and correct distinctions between either products or persons. One percentage rate applying to everything can become automatic.

14. *Decision required: Withholding of employee fringe benefits.*

At present, employers withhold from employee salaries and wages amounts for Social Security retirement, health benefits and other advantages. Here the alternatives are (a) continue as is, possibly simplifying by reducing government requirements for frequency of reports and payment; or (b) finding a way to cover this entire system into general revenue funds, to be serviced by the general level of the new retail sales tax.

15. *Tax avoidance and penalties.*

Stiff penalties are needed against individuals and conspiracies seeking to defraud or to avoid the sales tax. Businesses, cooperatives, and buying groups acquiring products for consumption by any individual should pay retail sales taxes. This includes bonuses, benefits, and gifts (except money).

16. *Enforcement and record-keeping.*

For enforcement purposes, it will be necessary at times to compare retail purchases with sales records.

17. *Ample personnel and expertise.*

Personnel of the Treasury Department who have administered the much more complex and difficult income tax collection system should be more than ample in skills and number to administer a much simpler retail sales tax.

18. *Objections.*

For some reason, nobody seems willing to entertain the idea of a national sales tax long enough to give it serious consideration.

An ex-director of the Congressional Budget Office casually remarked that the principal reasons against it were two: It would encourage savings; besides, the

States would not like this intrusion on their private domain. A Senator dismissed it as "regressive".

Counter arguments say: The U.S.A. needs savings. Our savings rate is lower than most nations—including Japan. "Regressive" is not a dirty word; it means if more people share taxes more equally, it hurts everybody less. There is no reason why the Federal and State Governments in every state could not set a single sales tax rate that would collect revenues for both at less trouble to the taxpayer. The governments could get its share at any time.

People paying no taxes or less taxes because of preferential tax treatment might consider they are now better off competitively than if nobody paid income taxes and everybody paid equal sales taxes. That would take government out of helping one side or the other in private enterprise competition.

Many people earn their livelihood only because present income tax regulations are too complicated for people to understand who earn their livelihood in other ways. They could hardly be expected to approve the simplicity of sales taxes.

Some believe that the heritage of "tax tax-spend spend-elect elect has continued for 50 years to use taxing and spending (in not always visible ways) to influence ever widening blocs of voters to return incumbants to office.

This report assumes a vast majority in Congress would like to be relieved forever from pressures about taxes by special interest groups. A permanent solution to the problem of raising federal revenues—and one easily changed up or down, with even-handed effects—should free time and effort for more important work than deciding between requests for unfair advantages.

NEW YORK, NY, *March 12, 1985.*

Mr. JOSEPH K. DOWLEY,
Chief Counsel, Ways and Means Committee,
Longworth House Office Building, Washington, DC.

MR. DOWLEY: The much publicized simplification of the tax system is worthwhile; but while streamlined tax laws are appropriate, the efficiencies of certain sections of the proposal do not make economic sense. Specifically, the proposed one-third reduction to the employer-provided retirement plan funding and the taxation of employer-provided welfare benefits, such as life and medical insurance, are mistakes. First, the programs contribute to the future security of the people. Second, they are incentives for people to work hard to earn the full extent of such benefits as now permitted by law. As a 33 year-old citizen, I can't help but have serious doubts about the value of social security to my generation. It would be a huge mistake to discourage private funding by removing tax-deductible contributions.

There are other benefit-related issues in the proposals that are equally alarming, but for the moment, however, I will limit my comments.

Sincerely,

STEPHEN R. SCROGGINS.

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